98th Congress } JOINT COMMITTEE PRINT } S. Prt. 98-65
1st Session

A REPORT TO CONGRESS
ON
FEDERAL DEPOSIT INSURANCE

PREPARED BY THE

FEDERAL DEPOSIT INSURANCE CORPORATION,
FEDERAL HOME LOAN BANK BOARD, AND
NATIONAL CREDIT UNION ADMINISTRATION
BOARD

(In accordance with provisions of section 712, Public Law 97-320, the Garn-St Germain Depository Institutions Act of 1982)

PRINTED FOR THE USE
OF THE

COMMITTEE ON BANKING, HOUSING,
AND URBAN AFFAIRS
UNITED STATES SENATE
AND
COMMITTEE ON BANKING, FINANCE
AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

JUNE 1983

U.S. GOVERNMENT PRINTING OFFICE
21 14 O WASHINGTON : 1983

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402

H242-6
S242-4

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

JAKE GARN, Utah, *Chairman*

JOHN TOWER, Texas
JOHN HEINZ, Pennsylvania
WILLIAM L. ARMSTRONG, Colorado
ALFONSE M. D'AMATO, New York
SLADE GORTON, Washington
PAULA HAWKINS, Florida
MACK MATTINGLY, Georgia
CHIC HECHT, Nevada
PAUL TRIBLE, Virginia

WILLIAM PROXMIRE, Wisconsin
ALAN CRANSTON, California
DONALD W. RIEGLE, JR., Michigan
PAUL S. SARBANES, Maryland
CHRISTOPHER J. DODD, Connecticut
ALAN J. DIXON, Illinois
JIM SASSER, Tennessee
FRANK R. LAUTENBERG, New Jersey

M. DANNY WALL, *Staff Director*
KENNETH A. McLEAN, *Minority Staff Director*
JOHN T. COLLINS, *General Counsel*
CHARLES L. MARINACCIO, *Minority General Counsel*

HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

FERNAND J. ST GERMAIN, Rhode Island, *Chairman*

HENRY B. GONZALEZ, Texas
JOSEPH G. MINISH, New Jersey
FRANK ANNUNZIO, Illinois
PARREN J. MITCHELL, Maryland
WALTER E. FAUNTROY, District of Columbia
STEPHEN L. NEAL, North Carolina
JERRY M. PATTERSON, California
CARROLL HUBBARD, JR., Kentucky
JOHN J. LAFALCE, New York
NORMAN E. D'AMOURS, New Hampshire
STAN LUNDINE, New York
MARY ROSE OAKAR, Ohio
BRUCE, F. VENTO, Minnesota
DOUG BARNARD, JR., Georgia
ROBERT GARCIA, New York
MIKE LOWRY, Washington
CHARLES E. SCHUMER, New York
BARNEY FRANK, Massachusetts
BILL PATMAN, Texas
WILLIAM J. COYNE, Pennsylvania
BUDDY ROEMER, Louisiana
RICHARD H. LEHMAN, California
BRUCE A. MORRISON, Connecticut
JIM COOPER, Tennessee
MARCY KAPTUR, Ohio
BEN ERDREICH, Alabama
SANDER M. LEVIN, Michigan
THOMAS R. CARPER, Delaware
ESTEBAN E. TORRES, California

CHALMERS P. WYLIE, Ohio
STEWART B. McKINNEY, Connecticut
GEORGE HANSEN, Idaho
JIM LEACH, Iowa
RON PAUL, Texas
ED BETHUNE, Arkansas
NORMAN D. SHUMWAY, California
STAN PARRIS, Virginia
BILL McCOLLUM, Florida
GEORGE C. WORTLEY, New York
MARGE ROUKEMA, New Jersey
BILL LOWERY, California
DOUG BEREUTER, Nebraska
DAVID DREIER, California
JOHN HILER, Indiana
THOMAS J. RIDGE, Pennsylvania
STEVE BARTLETT, Texas

CONTENTS

Letters of transmittal:

	Page
Senator Garn, chairman, Senate Committee on Banking, Housing, and Urban Affairs	V
Congressman St Germain, chairman, House Committee on Banking, Finance and Urban Affairs	VII

Reports:

Federal Deposit Insurance Corporation	1
Federal Home Loan Bank Board	243
National Credit Union Administration Board	675

JAKE GARN, UTAH, CHAIRMAN

JOHN TOWER, TEXAS
JOHN HEINZ, PENNSYLVANIA
WILLIAM L. ARMSTRONG, COLORADO
ALFONSE M. D'AMATO, NEW YORK
SLADE GORTON, WASHINGTON
PAULA HAWKINS, FLORIDA
MACK MATTINGLY, GEORGIA
CHIC HECHT, NEVADA
PAUL TRIBLE, VIRGINIA

WILLIAM PROXMIRE, WISCONSIN
ALAN CRANSTON, CALIFORNIA
DONALD W. RIEGLE, JR., MICHIGAN
PAUL S. SARBANES, MARYLAND
CHRISTOPHER J. DODD, CONNECTICUT
ALAN J. DIXON, ILLINOIS
JIM SASSER, TENNESSEE
FRANK R. LAUTENBERG, NEW JERSEY

M. DANNY WALL, STAFF DIRECTOR
KENNETH A. McLEAN, MINORITY STAFF DIRECTOR

United States Senate
COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
WASHINGTON, D.C. 20510

June 2, 1983

To: Members of the Committee on Banking, Housing, and Urban Affairs

I am pleased to submit for the use of the Committee a Committee Print consisting of separate studies of the current federal deposit insurance system completed by the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, and the National Credit Union Administration Board.

The mandate for a major study of deposit insurance was embodied in Section 712 of the Garn-St Germain Depository Institutions Act of 1982 (P.L. 97-320).

Section 712 directed each of the three insurance agencies to focus its study on the following issues:

> "(1) the current system of deposit insurance and its impact on the structure and operations of depository institutions;
> "(2) the feasibility of providing depositors the option to purchase additional deposit insurance covering deposits in excess of the general limit provided by law and the capabilities of the private insurance system, either directly or through reinsurance, to provide risk coverage in excess of the general statutory limit;
> "(3) the feasibility of basing deposit insurance premiums on the risk posed by either the insured institution or the category or size of the depository institution rather than the present flat rate system;
> "(4) the impact of expanding coverage of insured deposits upon the operations of the insurance funds, including the possibility of increased or undue risk to the funds;
> "(5) the feasibility of revising the deposit insurance system to provide even greater protection for smaller depositors while fostering a greater degree of discipline with respect to large depositors;
> "(6) the adequacy of existing public disclosure regarding the condition and business practices of insured depository institutions, and providing an assessment of changes which may be needed to assure adequate public disclosure;
> "(7) the feasibility of consolidating the three separate insurance funds; and
> "(8) other related issues."

The agencies did an excellent job in conducting such thorough studies in a timely fashion, and I am sure that the Committee Print will be of assistance to us as we review the changes occurring in our nation's financial system.

Sincerely,

Jake

Jake Garn
Chairman

FERNAND J. ST GERMAIN, R.I., CHAIRMAN
HENRY B. GONZALEZ, TEX.
JOSEPH G. MINISH, N.J.
FRANK ANNUNZIO, ILL.
PARREN J. MITCHELL, MD.
WALTER E. FAUNTROY, D.C.
STEPHEN L. NEAL, N.C.
JERRY M. PATTERSON, CALIF.
CARROLL HUBBARD, JR., KY.
JOHN J. LaFALCE, N.Y.
NORMAN E. D'AMOURS, N.H.
STAN LUNDINE, N.Y.
MARY ROSE OAKAR, OHIO
BRUCE F. VENTO, MINN.
DOUG BARNARD, JR., GA.
ROBERT GARCIA, N.Y.
MIKE LOWRY, WASH.
CHARLES E. SCHUMER, N.Y.
BARNEY FRANK, MASS.
BILL PATMAN, TEX.
WILLIAM J. COYNE, PA.
BUDDY ROEMER, LA.
RICHARD H. LEHMAN, CALIF.
BRUCE A. MORRISON, CONN.
JIM COOPER, TENN.
MARCY KAPTUR, OHIO
BEN ERDREICH, ALA.
SANDER M. LEVIN, MICH.
THOMAS R. CARPER, DEL.
ESTEBAN E. TORRES, CALIF.

U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
NINETY-EIGHTH CONGRESS
2129 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, D.C. 20515

CHALMERS P. WYLIE, OHIO
STEWART B. McKINNEY, CONN.
GEORGE HANSEN, IDAHO
JIM LEACH, IOWA
RON PAUL, TEX.
ED BETHUNE, ARK.
NORMAN D. SHUMWAY, CALIF.
STAN PARRIS, VA.
BILL McCOLLUM, FLA.
GEORGE C. WORTLEY, N.Y.
MARGE ROUKEMA, N.J.
BILL LOWERY, CALIF.
DOUG BEREUTER, NEBR.
DAVID DREIER, CALIF.
JOHN HILER, IND.
THOMAS J. RIDGE, PA.
STEVE BARTLETT, TEX.

225-4247

June 7, 1983

Dear Colleague:

Transmitted herewith is a Committee Print containing the studies conducted by the Federal deposit insuring agencies on Federal deposit insurance. I concur with the remarks of Chairman Garn and believe that this document should provide timely reading.

During the last Congress this Committee issued a document entitled, "Financial Institutions in a Revolutionary Era" which posed a series of questions and issues regarding the financial services industry. Central to those issues was a concern about the direction that Federal deposit insurance should take in the future. These studies provide thoughtful responses to that concern.

Sincerely,

Fernand J St Germain

Fernand J. St Germain
Chairman

Deposit Insurance in a Changing Environment

A study of the current system of deposit insurance pursuant to Section 712 of the Garn-St Germain Depository Institution Act of 1982, submitted to the United States Congress by the Federal Deposit Insurance Corporation

Federal Deposit Insurance Corporation
April 15, 1983

Board of Directors:
William M. Isaac, Chairman
C.T. Conover, Director
Irvine H. Sprague, Director

FDIC

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C. 20429

OFFICE OF THE CHAIRMAN

April 15, 1983

Honorable Jake Garn, Chairman
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, D.C. 20510

Honorable Fernand J. St Germain, Chairman
Committee on Banking, Finance and Urban Affairs
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairmen:

In accordance with Section 712 of the Garn-St Germain Depository Institutions Act of 1982, we are transmitting a copy of the deposit insurance study required by the Act. We commend you for this legislative mandate.

The present deposit insurance system has served the country well during the past 50 years. It has fostered public confidence in depository institutions and stablized the financial system. However, the time has come to look ahead. New technologies, new entrants into financial markets, deregulation and economic circumstances require that we consider whether the current system is equal to tomorrow's challenges.

Your foresight in initiating this review is appreciated, and we are pleased to be a part of the effort. We trust the enclosed study will contribute to an intelligent, informed discussion of the issues.

Sincerely,

William M. Isaac
Chairman

Enclosure

FOREWORD

Last fall I was informed by a member of our Congressional liaison staff that Congress wanted to place into the Garn-St Germain Act a requirement that the three Federal deposit insurance agencies individually study possible reforms to the deposit insurance systems and procedures. We were elated. The concerns we had been expressing were being heard; we had a forum.

The banking system -- indeed, the entire financial-services industry -- has been undergoing profound change in recent years. New technologies, economic circumstances and marketplace innovations have rendered obsolete the basic regulatory constraints fashioned a half-century ago and have forced deregulation upon us.

Frankly, the FDIC welcomes deregulation. If approached sensibly by government and industry leaders, it will greatly benefit the American public and the banking industry, possibly after a painful transition for some banks. If mishandled, however, deregulation could be a prescription for disaster.

We must seek new ways, in the absence of rigid government controls on competition, to limit destructive competition and excessive risk-taking. There are only two alternatives. We can promulgate countless new regulations governing every aspect of bank behavior and hire thousands of additional examiners to enforce them. This approach would undercut the benefits sought through deregulation, would favor the unregulated at the expense of the regulated, and would ultimately fail.

The FDIC much prefers the other alternative: seeking ways to impose a greater degree of marketplace discipline on the system to replace outmoded government controls. This is one of the two major themes of this Study.

The second is that in a deregulated environment the regulatory and insurance systems must be as effective, efficient and equitable as possible. The current systems are woefully inadequate on all three counts.

The Study, which contains a wealth of information about the financial and regulatory systems, is divided into two sections. The first section contains the body of the Study and the second section the appendices. The seven chapters in the first section are conveniently organized, and each contains an executive summary at the beginning. Ahead of Chapter I is an overall executive summary, which presents the Study's major findings and conclusions.

The Study was prepared solely by FDIC staff, although comments were received from a wide variety of sources in the financial community and elsewhere, and Dr. Carter H. Golembe provided valuable advice. It has been a monumental undertaking, particularly in view of the time frame for completion and the press of other business.

I would like to express appreciation to the FDIC's management group under whose general guidance the Study was prepared: Margaret L. Egginton, Deputy to the Chairman; Stanley C. Silverberg, Director of the Division of Research and Strategic Planning; James A. Davis, Director of the Division of Liquidation; Thomas A. Brooks, General Counsel; Robert V. Shumway, Director of the Division of Accounting and Corporate Services; and, most especially, James L. Sexton, Director of the Division of Bank Supervision. Heartfelt thanks are due also to Mary T. Mitchell, Associate Director of the Division of Bank Supervision, and her deputy, Jesse G. Snyder, under whose direction the Study was prepared. Finally, words cannot adequately express appreciation for the efforts of the staff members listed on the pages following this Foreword who devoted thousands of hours researching and preparing the Study.

A number of major reforms are suggested in the Study. We believe they are urgently needed. We do not expect, however, that they will be implemented without extensive debate. We hope the Study will contribute toward an intelligent, informed discussion of the issues.

The FDIC celebrates its 50th anniversary this year. It has served our Nation extraordinarily well thanks to the untiring service of thousands of people like those who prepared this Study. I know of no more competent and dedicated group of people in or out of government.

Our singular objective at the FDIC is the maintenance of a sound, responsive financial system under private ownership and control. It is toward that end we offer this Study.

William M. Isaac,
Chairman

April 15, 1983

FDIC STAFF CONTRIBUTORS

Coordination and Editorial Review: Kenneth Fulton
Mary T. Mitchell
James L. Sexton
Jesse G. Snyder

Chapter

I. CURRENT SYSTEM OF DEPOSIT INSURANCE AND ITS IMPACT

Authors: Stanley C. Silverberg
William R. Watson

II. RISK RELATED INSURANCE PREMIUMS

Author: David C. Cooke

Contributors: Harry F. Beerman
John F. Bovenzi
Colin W. Cooke
James A. Marino
Frank E. McFadden
Marlene A. O'Neill

III. MARKET DISCIPLINE AND THE FEDERAL DEPOSIT INSURANCE SYSTEM

Authors: Dean Forrester Cobos
David C. Cooke
Mary T. Mitchell
James L. Sexton
Stanley C. Silverberg

Contributors: James A. Davis
Myers N. Fisher
Douglas J. Jones
Daniel W. Persinger

IV. PUBLIC DISCLOSURE PRACTICES

Authors: Paul L. Sachtleben
Robert F. Storch

Contributor: Lawrence H. Pierce

V. ADEQUACY OF THE INSURANCE FUND AND REVISIONS TO ASSESSMENT PROCEDURES

Authors: Gary G. Gilbert
Stanley C. Silverberg
William R. Watson

Contributor: Benjamin B. Christopher

VI. MERGER OF THE DEPOSIT INSURANCE FUNDS

Author: Christie A. Sciacca

Contributors: Jules E. Bernard
James A. Marino
Robert F. Miailovich
Marlene A. O'Neill
Thomas C. O'Nell
Gary B. Sarsfield

VII. OPTIONAL EXCESS DEPOSIT INSURANCE

Authors: Dean Forrester Cobos
Jesse G. Snyder

Contributors: John F. Bovenzi
James A. Marino
William R. Watson

Appendices

A LITERATURE ON RISK RELATED INSURANCE SYSTEMS FOR COMMERCIAL BANKS

John F. Bovenzi and James A. Marino

B LITERATURE ON FAILURE PREDICTION MODELS FOR COMMERCIAL BANKS

John F. Bovenzi and James A. Marino

C EXISTING DISCLOSURE VEHICLES

Mary Sheehan Frank, Doris L. Marsh, David J. Seermon and Robert F. Storch

D ASSESSMENT PROCEDURES AND ISSUES

Benjamin B. Christopher and Gary G. Gilbert

E THE FINANCIAL STATEMENTS OF THE FEDERAL DEPOSIT INSURANCE CORPORATION

F SMALL DEPOSITOR PROTECTION

James J. Bartoszek, Richard L. Hickman, Thomas C. O'Nell and Robert W. Walsh

G STATE DEPOSIT INSURANCE PROGRAMS

Jay D. Karp, Steven Seelig and Detta Voesar

Technical Coordination and Reproduction:

Nils W. Larsen, Geri Pavey, Ken A. Quincy, and Geoffrey L. Wade

Clerical Support:

Joyce Breen
Suzanne L. Brown
Gracie B. Eison
Leah M. Kerr
Wanda M. Lockhart
Mary L. McCoy
Mildred M. McKinnis
A. Merle Rives
Brenda H. Tolliver

PROLOGUE

> "On March 3 banking operations in the United States ceased. To review at this time the causes of this failure of our banking system is unnecessary. Suffice it to say that the government has been compelled to step in for the protection of depositors and the business of the nation."

As President Franklin D. Roosevelt spoke those words to Congress on March 9, 1933, the Nation's troubled banking system lay dormant. The clamor of an excited public had subsided; the panic was over. The President had brought the financial chaos to an end by the proclamation of a "Banking Holiday," and only the sounder institutions would be allowed to reopen.

The reasons the banking system lay in ruin were many and varied, but an important immediate factor was a volatile and anxious public that was heavily at risk and was so sensitive to news and unfounded rumor that the spontaneous "run" became a commonplace horror for bankers.

Across a span of 50 years exists a very different problem. The hyperliquidity and extreme caution of once-burned bankers has gradually given way to highly-leveraged, aggressive banking practices. Regulators and bankers debate in academic terms the proper level of capital, and of liquidity, while bank creditors, whose interests are supposedly at stake, watch with little interest, if any at all.

There are, some believe, two kinds of banks -- small ones, which are perceived as having risk for creditors, and large ones, which are not generally so perceived and which can experience one well-publicized adversity after another, and yet compete with the best banks for funding. Moreover, the paucity of useful disclosure allows banks with very different degrees of soundness to be held in equal esteem by those who supply their funding.

The discipline of 1933 was meted out with little precision or fairness. Federal deposit insurance was wisely interposed against the passing of such irrational and ruinous judgment. But in 1983, the burden of discipline has fallen too heavily on the deposit insurance system, and financial institutions no longer behave as though the quick and efficient reaction of the marketplace is to be feared.

If the Nation's marginally-operated banks incur no penalty, then a corollary is that good banking practice receives too little credit and recognition. It is of no small consequence that, while this indifference is growing, deregulation and enhanced banking powers are heightening the need for a more discerning and rational market.

This fundamental inconsistency is what this Study is about.

James L. Sexton,
Director, Division
of Bank Supervision

April 15, 1983

CONTENTS

Page

EXECUTIVE SUMMARY . . . iv

Chapter

I THE CURRENT SYSTEM OF DEPOSIT INSURANCE AND ITS IMPACT ON THE STRUCTURE AND OPERATIONS OF BANKS I-1
  Executive Summary I-1
  Introduction I-2
  Historical Overview I-2
  The Period 1942 - 1972 . . . . I-4
  The Period 1972 - Present I-5
  The FDIC and Current Banking Structure I-6

II RISK-RELATED INSURANCE PREMIUMS II-1
  Executive Summary II-1
  Introduction II-2
  Merits of Risk-related Premiums II-2
  Costs and Tradeoffs II-4
  General Approach II-5
  Focus of Risk Evaluation II-5
  Available Data Sources II-7
  CAMEL for Risk Premiums II-8
  Proposed Approach II-9
  Risk Measurements II-10
    Capital II-10
    Credit Risks II-11
    Interest Rate Risks II-13
    Moral Hazards II-15
    Liquidity II-16
  Premium Determination Dates II-16
  Appeals Process II-16
  Size and Risk II-17
  CAMEL and Supervisory Costs II-21

III MARKET DISCIPLINE AND THE FEDERAL DEPOSIT INSURANCE SYSTEM . . III-1
  Executive Summary III-1
  Introduction III-4
  Risk Sharing and Insurance Protection III-4
    Modified Payoff III-4
    Coinsurance III-6
  Capital Standards III-7
  Depositor Preference III-9
  Administrative and Operational Considerations III-10

Chapter Page

IV PUBLIC DISCLOSURE PRACTICES IV-1
  Executive Summary IV-1
  Introduction IV-2
  Functions of Disclosure IV-2
    Enhance Market Discipline IV-2
    Protect Bank Depositors and Other Customers IV-3
  Other Considerations Bearing on Disclosure IV-4
    Reporting Burden on Banks IV-4
    Public Nonuse of Data IV-5
    Potential Public Overreaction to Disclosures IV-7
  Adequacy of Disclosures IV-7
    Information Currently Available to the Public IV-7
    Available Information and User Needs IV-10
    Data Withheld From the Public But Available to Regulators. IV-11
    Reports of Examination IV-11
    Administrative Actions IV-11
    Country Lending Survey IV-12
  FDIC Position on Public Disclosure IV-13
    Educate the Public IV-13
    Make More Information Available to the Public IV-14
    Evaluate Agency and Public Data Needs IV-16

V ADEQUACY OF THE INSURANCE FUND AND REVISIONS TO ASSESSMENT PROCEDURES V-1
  Executive Summary V-1
  Introduction V-2
  Financial Operations of the FDIC V-2
  Determining the Adequacy of the Deposit Insurance Fund . . . V-3
  Borrowing Authority V-8
  Assessment Procedures V-8

VI MERGER OF THE DEPOSIT INSURANCE FUNDS VI-1
  Executive Summary VI-1
  Introduction VI-2
  Arguments for Merging the Funds VI-2
    Similarities of Insurers VI-2
    Insurance Premiums VI-2
    Regulatory and Supervisory Powers VI-3
    Insurance and Supervision VI-4
    Similarities of Insured Institutions VI-4
    Risk Diversification and Strength of the Funds VI-5
    Changes in Charters and Interindustry Mergers VI-7
    Reporting and Surveillance VI-8
    Separation of Insurance From Chartering and Regulation . . VI-8
  Arguments Against Merging the Funds VI-9
    Conflict With Other Public Policies VI-9

Chapter Page

Loss of Industry Orientation VI-10
The Question of Equity VI-10
Public Confidence VI-10
Merging the Funds VI-10
Single Pool VI-11
Separate Pools VI-11
Phase-in VI-12
Supervisory Framework VI-12

VII OPTIONAL EXCESS DEPOSIT INSURANCE VII-1
Executive Summary VII-1
Introduction VII-1
Demand For Excess Coverage/Money Brokers VII-1
The FDIC as Suppliers of Excess Coverage VII-2
Semipublic Suppliers of Excess Coverage VII-3
Banks as Self-Insurers VII-4
Private Insurance Companies VII-4
Capacity Contraints VII-5
Inability to Assess and Control Risk VII-5
Other Potential Barriers VII-7
Diversification of Risk VII-7
Safety and Liquidity Considerations VII-7
Settling Depositor Claims VII-8
Alternatives for Private Sector Expansion VII-8
Public Demand and Government Involvement VII-9

APPENDICES

A LITERATURE ON RISK-RELATED INSURANCE SYSTEMS FOR COMMERCIAL BANKS

B LITERATURE ON FAILURE PREDICTION MODELS FOR COMMERCIAL BANKS

C EXISTING DISCLOSURE VEHICLES

D ASSESSMENT PROCEDURES AND ISSUES

E THE FINANCIAL STATEMENTS OF THE FEDERAL DEPOSIT INSURANCE CORPORATION

F SMALL DEPOSITOR PROTECTION

G STATE DEPOSIT INSURANCE PROGRAMS

EXECUTIVE SUMMARY

INTRODUCTION

It is not hyperbole to characterize the changes now taking place in the financial system as revolutionary. A structure put into place a half century ago, at the bottom of one of the Nation's greatest Depressions, is crumbling, and a new structure is rapidly taking shape. In part this is occurring by design but in larger part it is because of the forces of economics and technology. The central question facing the government today is not whether change will or should continue but, rather, how to assure that the financial structure that eventually results is one that will best serve the public interest.

Deposit insurance has been an integral part of the financial system for almost a half century, responsible in considerable part for the depository institution structure that has evolved and the nature of the supervision and regulation of depository institutions. It is, therefore, impossible to consider any government action taken in connection with the changing financial structure without addressing the role of the insuring agencies. Congress recognized this when, in the Garn-St Germain Depository Institutions Act of 1982 (henceforth Garn-St Germain), it directed those agencies to address themselves to insurance issues likely to be of significance in the new financial environment. This report sets forth the views of the FDIC, the first of the deposit insurance agencies to be established and by far the largest in terms of assets, potential insurance liabilities and personnel.

Perspective is useful. Briefly, a group of Federal statutes adopted in the early and mid-1930s — the most important of which probably were the Banking Act of 1933 (including, among other provisions, the establishment of the FDIC), the Home Owners' Loan Act of the same year, the Securities Act of 1933 and the Securities Exchange Act of 1934 -- were responsible for establishing a financial structure that was neatly-compartmentalized and tightly-regulated. The powers of financial institutions were carefully differentiated and in some instances were made highly specialized, so that, for example, only investment banking houses were able to underwrite corporate securities and only commercial banks could offer demand deposit services. In general, what was contemplated was a system of specialized financial institutions, with some necessary overlap.

For depository institutions, the cost of raw materials, i.e., of deposits, was regulated for the first time at the Federal level, with a zero interest ceiling applied to demand deposits, and administratively-determined ceilings applied to savings and time deposits. Also for depository institutions, geographic expansion was constrained within state boundaries (and within the states, continued to be governed by state law). Entry into the business of accepting deposits became more tightly-regulated as a result of the establishment of the deposit insurance programs.

Separate regulatory systems were created or maintained. Institutions such as the SEC, the FDIC and the FHLBB were created in the various pieces of legislation of the early 1930s. Coordination among such agencies in different fields was not a matter of primary concern; the various groups of financial institutions were believed to be sufficiently insulated by reason of their carefully-drawn spheres of activity to make any special provision for coordination unnecessary.

The rationale for the establishment of the kind of system described was clear -- Congress and the Administration were determined to make impossible a recurrence of the catastrophic financial collapse of 1930-1933. Underlying much of the new legislation was a pervasive belief -- which extended to nonfinancial fields -- that a root cause of the economic collapse had been excessive competition. The system devised was intended, among other things, to restrain competition, not only among financial industry groups but even within the banking industry itself.

As with any set of regulations superimposed on an essentially competitive business, some erosion occurred over the years in the various lines of demarcation and in other constraints. However, the system remained essentially unchanged until the late 1970s, when it began to disintegrate rapidly. The major reasons for that development include the communications-computer revolution, the long period of inflation and high interest rates, the 180-degree change that had occurred in the attitude of government toward competition among financial institutions (now viewed as a desirable objective rather than something to be prevented), and entrepreneurial vigor on the part of the managers of financial institutions, particularly as the financial demands from the public became larger and more complex.

The kinds of change that have taken place recently are well known. Deposit interest regulation has largely disappeared; the powers of the thrift institutions were substantially expanded when it became apparent that specialization in long-term fixed lending to purchasers of residential properties could not be sustained in a period of high and volatile market interest rates; and in a variety of ways the new financial technology is utilized to do business over broader geographic areas than were contemplated in the legislation of a half century ago. We are rapidly reaching a situation in which virtually any financial service may be offered by any financial institution on a nationwide basis. Deregulation -- the more usual term for the dismantling of the system constructed in the early 1930s -- is in full swing.

The adoption of a deposit insurance program in 1933 was outside of the mainstream of financial reform legislation of the time. The insurance legislation was not a part of the Administration's program and many persons, both within and outside of the Administration, held out little hope for its success. The record of state attempts to operate deposit insurance systems, a record extending back more than a century prior to 1933, was not encouraging.

The result was far different from what pessimists expected. The significance of the deposit insurance legislation is perhaps best illustrated by the fact that two of the Nation's leading economists, persons whose views are usually thought of as being at opposite ends of the economists' spectrum, are as one on the importance of the deposit insurance sections of the Banking Act of 1933. Professor Milton Friedman has observed: "Federal insurance of bank deposits was the most important structural change in the banking system to result from the 1933 panic and, indeed in our view, the structural change most conducive to monetary stability since state banknote issues were taxed out of existence immediately after the Civil War." (A Monetary History of the United States, 1963). Professor John K. Galbraith has described the creation of the FDIC in the following terms: "The anarchy of uncontrolled banking (was) brought to an end not by the Federal Reserve System ("FRS") but by the obscure, unprestigious, unwanted Federal Deposit Insurance Corporation . . . in all American monetary history no legislative action brought such a change as this." (Money: Whence It Came, Where It Went, 1975).

Not only has deposit insurance, which was quickly extended to savings and loan associations by the Congress and later to credit unions, been a positive force for monetary stability, but it has also given to government a direct financial stake, of a type and magnitude not found with respect to any other industry, in the future course of deregulation.

In Garn-St Germain, Congress directed the three Federal agencies insuring deposits or share accounts to address seven specific questions, as follows:

1. The current system of deposit insurance and its impact on the structure and operations of depository institutions;

2. The feasibility of providing depositors the option to purchase additional deposit insurance covering deposits in excess of the general limit provided by law and the capabilities of the private insurance system, either directly or through reinsurance, to provide risk coverage in excess of the general statutory limit,

3. The feasibility of basing deposit insurance premiums on the risk posed by either the insured institution or the category or size of the depository institution rather than the present flat-rate system;

4. The impact of expanding coverage of insured deposits upon the operations of insurance funds, including the possibility of increased or undue risk to the funds;

5. The feasibility of revising the deposit insurance system to provide even greater protection for smaller depositors while fostering a greater degree of discipline with respect to large depositors;

6. The adequacy of existing public disclosure regarding the condition and business practices of insured depository institutions, and providing

an assessment of changes which may be needed to assure adequate disclosure;

7. The feasibility of consolidating the three separate insurance funds.

Each of the items on which the FDIC and its sister agencies were asked to comment touches on an important aspect of the insurance program. The discussion that follows summarizes the FDIC's views and recommendations with respect to the noted questions, placed in the broader context of deposit insurance reform. For it seems evident that in posing its specific questions, important as they are individually, Congress was really raising the fundamental question of whether the deposit insurance program now in place should be altered in order to accommodate, or to help shape, the sweeping changes that are taking place in the Nation's financial system.

DEPOSIT INSURANCE OBJECTIVES

An inquiry on the role that deposit insurance should play in a deregulated environment must begin with the objectives of the insurance program. This is essential to determining whether or to what extent significant reform is necessary, and whether any recommended changes will serve the public interest.

The subject of deposit insurance was debated in the U.S. Congress for at least 50 years prior to its adoption in 1933, and deposit insurance systems had been instituted at various times by 14 states between 1829 and 1917, several of which state plans continued until the early 1930s. From this extensive record, two public policy objectives have emerged with consistency: first, that deposit insurance should protect depositors of modest means from the consequences of bank failure and, second, that such insurance should protect communities, states, or the Nation against the economic consequences of bank failure.

The first of these objectives requires little in the way of elaboration. Whether, as in the early 19th century, it was because there were many individuals who could not distinguish among the circulating banknotes that they were compelled to accept in the form of wages or, as in 1983, because individuals require a place to deposit savings or for paying small checks, it is a fact that there are large numbers of persons whom society has, in effect, compelled to use banking facilities, and yet these people have little ability to protect themselves against the risk of a bank's closing. Probably there has never been a better statement of this particular objective, or at least one made more elegantly, than by a committee of the New York legislature in 1819, when that state was about to adopt the Nation's first deposit insurance system:

> The loss by the insolvency of banks falls generally upon the farmer, the mechanic, and the laborer, who are least acquainted with the condition of banks and who, of all others, are most illy able to either guard against or to sustain a loss by their failure. (New York Assembly Journal, 1829, p. 439).

The second objective has been stated in a variety of ways. One of these takes account of the fact that the liabilities of the Nation's commercial banks comprise a major portion of the circulating medium, and thus holds that the principal purpose of deposit insurance is to prevent destruction of the circulating medium because of bank failure. This particular kind of statement was probably more applicable to the state insurance systems of the 19th century, and to the conditions that prevailed in the early 1930s. Today, one is more likely to hear the objective framed in terms of safety of the payments mechanism, or of the severe contractive effect, in a fractional reserve banking system, that would ensue if there were a stampede toward the conversion of deposits into cash.

However stated, this second objective of deposit insurance relates to the contribution that deposit insurance makes to financial stability, and it is that contribution to which Messrs. Friedman and Galbraith, quoted earlier, made reference. Indeed, in much of the academic literature, the financial stability role of deposit insurance is identified as the only significant objective assigned to the deposit insurance program.

Those who sought deposit insurance legislation in 1933 saw other benefits to be obtained, of more immediate and practical importance. One, rather clearly, was the idea that government intervention in the form of a deposit insurance program might introduce some stability into a chaotic situation and help restore public confidence in a banking system that had virtually collapsed. Today most would agree that maintenance of public confidence in banking is simply an alternative formulation of the financial stability role played by the FDIC.

There was also the strong belief in 1933 that only a deposit insurance program would enable smaller independent banks to survive and compete successfully with larger banking institutions. Thus, among the most vigorous supporters of the deposit insurance legislation were the Nation's smaller banks, particularly in the middle west, the plains states, and the southeastern states -- areas particularly hard hit by bank failures.

The FDIC managed to satisfy the cluster of aspirations and objectives sought by those who had put the insurance legislation in place; this, as was mentioned earlier, was to the surprise of many if not most observers. Confidence in the banking system did in fact reappear, even though initial insurance coverage was only $2,500 per depositor (quickly raised to $5,000, where it remained until 1950). The record of depositor protection has been outstanding: over a period of 49 years, the FDIC has made disbursements to protect over six million depositors in the 620 insured bank failures since 1933, resulting in recovery by depositors of $19.7 billion, or 98.9 percent of insured and uninsured deposits in failing banks.

It would be difficult to argue that the past 50 years have not witnessed periods of monetary or financial instability. Nonetheless, such instances have not been caused or exacerbated by monetary "panics" or by the waves of bank failures that had plagued the American economy for a century and a half prior to 1933. Indeed, the total number of insured bank failures since 1933 has not been very much greater than the average number of bank failures in any single year during the prosperous period of the 1920s, and of course far below the failure record of the early 1930s when, during the period 1930-1933, some 9,000 commercial banks closed their doors.

Numerous factors have played a part in shaping the present banking structure, and deposit insurance is not the least important among them. To the extent that preservation of that structure may be characterized as an objective of deposit insurance, it is an objective attained. The banking structure in 1983, whether viewed in terms of number of banking institutions or their distribution by size (size in "real" terms, of course), does not differ significantly from that which was in place on January 1, 1934, the date that Federal deposit insurance became effective.

When the record of the past half century is viewed in terms of policy actions taken by the FDIC or by the Congress, it is evident that the financial stability objective has been of special importance. Initially, the only authority provided by the Congress to the FDIC was to arrange for the payment of depositors, up to the insurance maximum, after a bank was closed and placed in liquidation. In 1935 an almost innocuous and certainly well-intentioned change in the law gave to the FDIC authority to facilitate mergers among insured banks whenever the FDIC could find that the merger was likely to eliminate a weak institution. It was thought that by doing so the FDIC would be able to avoid larger disbursements at some future time, when many such banks could be expected to fail. By the late 1940s, assisting weak banks to merge had gradually been transformed by the FDIC into an alternative method of handling failing banks, and by the middle 1960s, the modest merger-assistance program had become thoroughly integrated into FDIC procedures for protecting depositors, complete with cost tests, the use of receiverships in arranging assisted mergers, and the introduction of "premiums" and bidding procedures. What emerged is what is known today as the purchase and assumption transaction (P&A).

During the past 30 years, the majority of bank failures, and practically all larger bank failures, have been handled through the P&A. In this kind of transaction, the FDIC replaces the bad assets with cash and all deposits and other nonsubordinated liabilities of the failed bank are assumed by another (existing or new) bank. As a result, no general creditor incurs any loss, despite the closing of a bank. On a few occasions the FDIC has provided direct assistance to banks that were open but would otherwise have failed. Recently it has also provided direct assistance to facilitate open-bank mergers of failing savings banks. In these transactions, like P&As, all depositors are made whole.

Various reasons account for the frequent use by the FDIC of the P&A when handling a distressed bank. In most instances a P&A is actually less expensive to the FDIC than simply paying insured depositors only the amount of their insured deposits, because the acquiring institution is frequently willing to pay an attractive premium to acquire a failing bank, once its bad assets have been purchased by the FDIC. For purposes of this discussion, however, the key point is that the P&A enables the FDIC to implement its monetary stability objective in a way that might be impossible if the FDIC had only the option of paying insured depositors directly.

The P&A transaction is almost always less disruptive for individual depositors, bank loan customers, local merchants, and the general community. Going beyond this, and particularly if the distressed institution is of large size, a P&A is almost dictated for the FDIC if the FDIC is to prevent disruptive consequences to financial markets. The failure of a large banking institution might well bring down other commercial banks and at the same time so adversely affect public confidence as to initiate the kind of banking crisis that deposit insurance had been intended to prevent.

The development and increasing use of the P&A transaction as one of the two principal ways of protecting depositors of failing banks was accomplished largely by administrative action on the part of the FDIC. Most recently, however, Congress has implied that it, too, accords special importance to this objective. In Garn-St Germain, for example, the authority of the FDIC to provide assistance to distressed insured banks, which authority under earlier law had hinged upon a finding that the continued operation of the institution was essential to its community, was changed so that the criterion is now a finding that "severe financial conditions exist which threaten the stability of a significant number of insured banks or of insured banks possessing significant financial recourses . . ." (Section III of Garn-St Germain).

In assessing the objectives that should guide deposit insurance policy in the future, heavy weight must be placed on the financial-stability objective. Indeed, that objective already is, or may soon become, "first among equals." And, it is this objective of maintaining financial stability that will pose the tough questions for planning the role that the insurance system should play as deregulation proceeds.

DEPOSIT INSURANCE IN A DEREGULATED ENVIRONMENT: THE PROBLEM

Deregulation of financial institutions is, in itself, an important public policy objective. Prior Administrations have made this clear (for example, in a January 1981 Report of the President), but none more so than the present Administration. Put most briefly, the objective might be stated as follows: consistent with the need to maintain a sound financial system, means must be found of removing those constraints from commercial banks and from other financial institutions that prevent the public from obtaining the benefits of competition among all financial institutions.

Against this background, what is the problem posed for, and by, deposit insurance? Banks, after all, have been able to fund themselves for many years with deposits that are Federally-insured; what difference does it make if now, or soon, these funds are purchased at market rates rather than regulated rates, or over broader geographic area, or if they may be employed in a variety of new financial services?

To a certain extent, of course, even before the pace of deregulation picked up so dramatically, the fact that privately-owned and competitive financial institutions were funded in substantial part by liabilities insured by an agency of the Federal government posed problems. This was the reason for the adoption of an extensive system of supervision and regulation of banks. What has changed is that a significant contraction in the scope of regulation has commenced while the government's deposit insurance obligation gives no evidence of contracting; indeed most signs point to further expansion of that obligation. One might have thought that the logical relationship would be a concurrent reduction both in regulation and in the government's exposure under the deposit insurance program, but this does not appear to be happening.

Until the 1970s, the FDIC's use of the P&A could have been regarded as nothing more than a commendable financial innovation, enabling the FDIC to provide the essential protection for depositors of failing banks in a manner that was least disruptive to the affected communities and most calculated to preserve financial stability. For many years, close observers of deposit insurance speculated openly that the FDIC, having developed the P&A, would be compelled to use it in any case involving a large distressed bank. Events during the 1970s have borne this out. There have been a fairly sizable number of large distressed insured banks, more than a few in the multibillion dollar category and, with one exception (Penn Square Bank), all large cases have been handled through either a P&A or direct assistance. Although it is not possible to say precisely when attitudes in the business and financial community began to change, there seems little question that sophisticated users of banking services are increasingly aware that the FDIC's options are indeed limited.

The scope of the government's insurance obligation has also been expanding in other ways. Insurance coverage, which was raised to $10,000 in 1950, is now set by statute at $100,000 per depositor -- a ten-fold increase. If change had been restricted to that called for by inflation (measured by the Consumer Price Index), insurance coverage today would be only about $40,000 per depositor. Moreover, it is not unusual to hear suggestions that coverage per depositor be increased even further, but rarely or ever are there suggestions that it be reduced.

In Garn-St Germain the Congress further broadened the insurance responsibility in that capital assistance programs for failing depository institutions were added to the functions of the insurance agencies. The point to be made here does not relate to the merits of such action but is simply that this action by the Congress is still another indication that the breadth of the insurance commitment on the part of the Federal government tends to continue growing, at a time when regulation which buttressed that commitment is diminishing.

The problem is that deposit insurance may come to exert a perverse effect -- furthering rather than containing financial instability. This may happen if the combination of government underwriting of deposit risk and the natural tendency of institutions to trade on this advantage is not checked by offsetting constraints imposed by government, or by the market, or both. An increasingly fragile financial structure might be unable to resist even minor shocks. The not insignificant side effects could be a substantial increase in the cost of insurance, or the prevention of such fragility could call for the slowing down or end of the deregulation process. Put somewhat differently, comprehensive government insurance of liabilities is inconsistent with deregulation of the institutions responsible for those liabilities; it is unlikely that government can allow deregulation to proceed much further without addressing the insurance connection. Yet, to check the deregulation movement would mean the thwarting of an important public policy objective — the attainment of more effective competition among financial institutions.

DEPOSIT INSURANCE IN A DEREGULATED ENVIRONMENT: SOME POSSIBLE SOLUTIONS

If, as the FDIC believes, meaningful deregulation requires, at the same time, significant reform of the ways in which the deposit insurance programs now operate, then a variety of possibilities exist. Deregulation may also call for a restructuring of the insurance agencies, a subject that Congress asked the FDIC to address and which is considered in the following section. This section is concerned with possible reform internal to FDIC, or to its procedures, and in the course of the discussion will address the specific questions posed by the Congress in the Garn-St Germain Act.

Reform recommendations, the FDIC's and those of others, can be grouped in various ways. One that has some attraction is to consider, first, those that call for action by the government (i.e., primarily by the FDIC) and, second, those that look to the private sector for assistance. Before looking at each of these groups, comment on a quite different matter may be useful.

Special Reform Proposal

It has been suggested that banking organizations can be deregulated without the need of altering the insurance system, at least so far as product and geographic deregulation is concerned, by providing that new activities be conducted outside of the bank, in affiliated institutions, and that dealings between the bank and its affiliates be prohibited or strictly regulated. Deposit insurance would relate only to the bank, which would, in effect, be sealed off from the other affiliates in the holding company.

There is fairly extensive literature dealing with this kind of reform, and it is one that has recently been suggested to the Congress by the Treasury Department. Although no precise tabulation has ever been made, the weight of opinion seems to be that it is impractical to think that the future of the bank can be separated from the future of the company of which it is a part. The public, it is argued, will inevitably view the institution as one.

There is, on the other hand, the contention that real separation has never been actively attempted or pursued by regulatory authorities, and that the proposal is in fact workable, not only as a matter of law (about which there is little question) but also in practice. Regardless of the respective merits of the argument, this is a reform that lies outside the purview of this report. Nor does it deal directly with problems posed by interest-ceiling deregulation. It is, nonetheless, a reform that is certain to be before the Congress, and should not be overlooked.

FDIC Initiatives

Few reform proposals have had as long and as respectable a history as that which calls for risk-related premiums. Specifically, it is argued that the fact that the deposit insurance assessment rate is the same for all banks (1/12th of one percent of assessable deposits, less a net assessment income credit based on FDIC expenses and losses) means that there is no penalty attached to those banks that pose undue risk to the deposit insurance fund compared to those operated in more conservative fashion. Most limits on bank activities, and much bank supervision, could be dispensed with, it is argued, if each bank's insurance assessment were to be related to the risk that it assumes in the use of its deposits.

The theory is difficult to reject; but implementation is impractical. As pointed out in Chapter II of the study, the FDIC has concluded that establishment of an "ideal" risk-related premium system is not feasible. Among other reasons, it would entail unrealistic data requirements and would require more advanced risk quantification techniques than are currently imaginable. Even if these problems could be overcome, the authority over banks that would then devolve on the FDIC -- much of it necessarily judgmental in nature -- is far greater than is tolerable for any governmental agency in an economic society based on free-enterprise principles.

It is the FDIC's view, however, that simple fairness dictates some moderate differentials in deposit insurance rates to reward sound management and to penalize bank managements that refuse to conform to the most elementary standards of acceptable bank behavior. Accordingly, the FDIC proposes a risk-related premium program that is limited in scope with the maximum premium differential equal to the assessment credit. Also, the FDIC will seek authority to charge banks for any disproportionate amount of supervisory time required to correct problem bank situations.

It is possible that the limited program envisioned by the FDIC will, over time, evolve into a program that more closely meets the objectives of an "ideal" system. However, it is impractical, and possibly harmful, to attempt at this stage to institute a full-blown, risk-related assessment program.

Private Sector Initiatives

In the FDIC's view, better solutions to the problem set forth earlier are to be found in mobilizing the resources of the private market. A variety of possibilities exist. Several of them are quite promising.

Disclosure -- In one sense, the most useful of all reforms is not a reform but simply an extension of an existing practice. Specifically, the FDIC has concluded that there should be significant improvement in the disclosure of information to the public. How effective this will be will depend in part on the interest in, or usefulness of, the data, which in turn will depend on the extent to which additional risk is shifted from the FDIC to the private sector. However, even if no other change were made, to the extent that there is already a degree of private sector surveillance of banks, improved disclosure would enhance that surveillance.

The specific disclosure recommendations made by the FDIC are set forth in Chapter IV of the study. A policy statement has been developed, setting forth minimum standards for bank disclosure, encouraging banks to meet those standards and also encouraging uninsured depositors to request necessary information. A key element of the proposal would be management's narrative analysis of the bank's results of operations and financial position.

Bank Call Reports are presently in the midst of major revisions which will make their content more comprehensive for purposes of risk analysis. Two additions to these documents will provide the regulators and the public with data on credit-risk (loan quality) and interest-rate risk, areas not previously covered in these reports. An issue of competitive equity remains, however, as savings and loan associations do not disclose data on loan quality. The FDIC is also considering whether to adopt a policy under which there would be public knowledge of banks against which it has taken statutory enforcement actions. The FDIC would publish the final orders it issues in the Federal Register, on or around their effective dates.

Reducing effective insurance coverage -- If insured depository institutions have an incentive to act in a more risky fashion than the market would permit in the absence of insurance, and the only thing that has prevented this in the past has been the set of statutory and regulatory constraints on bank behavior, then it would follow that deregulation would pose financial stability problems for the FDIC and the Nation. A common sense approach to this problem would be to cut back on the de facto level of insurance coverage in order that some important portion of deposit liabilities is placed at risk. This should result in better policing of bank risk-taking proclivities by the private sector. In fact, the feasibility of obtaining more effective discipline from bank depositors, particularly those with larger balances, is precisely one of the matters that Congress has directed the insurance agencies to examine.

How might such a reduction in de facto insurance coverage be obtained? Such a result could be accomplished if the FDIC were simply to abandon use of the P&A and direct assistance procedures, and follow a policy henceforth of only paying depositors in failed insured banks the amounts of their deposits up to the statutory ceiling of $100,000. Institution of such a policy would unquestionably attract attention from large depositors, and yet would be perfectly consistent with the public policy objective of protecting unsophisticated depositors with modest balances.

There are several problems with this approach. One is that it would expose communities in which bank failures occur to needless distress. For reasons given earlier, the P&A is a better way in which to handle a bank failure and still avoid the disruptive consequences of such a closing. Much more importantly, however, adoption of the program mentioned above would seriously impair the FDIC's ability to achieve its second public policy objective, namely, to protect against the destabilizing effects of bank failure. No one can be certain, of course, what the result would be, but many competent observers believe that if the FDIC were to place all uninsured depositors at substantial risk, then the failure (or even reports of serious difficulties) of large banks might set off a chain of problems, threatening otherwise sound institutions. Put another way, such a program would make more likely the occurrence of bank runs that would have destabilizing effects like those that the FDIC was established in 1933 to prevent.

But between the two extremes of flat 100 percent insurance coverage for all depositors and rigidly paying off depositors only up to the insurance maximum, various possibilities exist for achieving worthwhile reform. That which appears most attractive to the FDIC is that the P&A transaction continues to be used in most instances, but that it be modified so as to introduce some risk-bearing by depositors with sizable balances.

Specifically, the FDIC is considering use of a procedure where, following a bank closing, the FDIC would make an immediate appraisal of the assets and an estimate of the ultimate recovery. This estimate would then be used in determining the extent to which depositors are protected in the failed bank. To illustrate: assume that in the case of a particular failed bank the FDIC estimates that recovery on assets would equal 80 percent of all claims by depositors (or by the FDIC on behalf of depositors it has paid) and other general creditors. The FDIC could then structure a transaction very much like the current P&A, but only insured deposits and, in this case, 80 percent of uninsured deposits and other liabilities would pass to the acquiring bank along with a similar volume of failed bank assets and cash (less any premium that the acquiring bank might be willing to pay). A variant on this approach, considered in Chapter III of the study, would provide by statute a fixed percentage recovery (such as 75 percent) on deposit balances over $100,000 irrespective of the ultimate recovery on assets.

A transaction modified in either of these ways would retain many of the advantages of the present P&A transaction. Some, though perhaps not all, of the goodwill and deposit relationships of the former bank would be preserved. While uninsured depositors would lose a portion of their funds, they would keep immediate access to most of their funds. If the ultimate recovery exceeds 80 percent, uninsured creditors would receive additional payments. Should the FDIC's ultimate recovery fall short of its initial estimate, then, presumably, the FDIC's share of the loss would exceed that of uninsured general creditors (in a regular P&A, it should be remembered, the FDIC bears all of the loss).

A modified P&A, while still providing uninsured depositors with a substantial portion of their deposits, would nevertheless expose them, as well as other general creditors, to risk, and thus persuade them to be more selective in their choice of banks, or to be more vigilant in monitoring the activities of the banks they select. It should be possible to use the modified P&A even in banks of quite large size, since under the proposed program even the largest uninsured depositors would receive, immediately, a very substantial portion of their deposits.

There is a risk entailed, even with this modified approach. Some observers with whom the FDIC has consulted have warned that any exposure to risk by large depositors may have destabilizing effects. It might, for example, bring back the problem of bank runs. In the FDIC's view, the program suggested is sufficiently modest to be unlikely to have such adverse consequences. Moreover, if, as many of these same critics point out, large depositors are already aware of their risk and monitor it closely; the change should not have the kinds of consequences suggested.

Nongovernment deposit insurance -- It is often suggested that the private insurance industry might be capable and desirous of shouldering a larger portion of the deposit insurance burden, now borne almost entirely by Government. Moreover, if the FDIC is successful in modifying its P&A procedures along the lines described earlier, additional insurance may be eagerly sought after by large depositors. Possibly these were among the reasons Congress asked for a discussion of the feasibility of offering excess coverage at the option of the purchaser, and of whether such excess coverage, if needed, could be provided by the private insurance industry.

For the FDIC itself to offer excess coverage would be redundant (the FDIC, for all practical purposes, now insures virtually all deposits) unless such an offer were part of a program to replace the P&A and other procedures, i.e., unless it were viewed as part of a return to a policy of providing insurance protection solely through deposit payoffs up to the insurance maximum. The major problem with FDIC participation in such an arrangement would be that of pricing the additional risk for the same reasons mentioned in the earlier discussion of risk-related premiums. If the FDIC felt confident that risk could be priced appropriately in this situation, then of course it would be confident that it could be done for all deposits.

Private insurance companies would face a similar problem of risk pricing. But quite apart from pricing problems, there are serious capacity constraints that suggest that private insurance coverage will continue in the future to remain as it is now, namely, fairly narrow in scope and focused on individual customers or selected institutions. As pointed out in Chapter VII of the study, the FDIC has discussed the subject with representatives from a selected group of companies and finds little reason to believe that comprehensive insurance programs can be made available from the private sector.

It may be premature to reach a conclusion on this. If the FDIC is able to modify its P&A procedure, new demands for excess insurance coverage might stimulate the development of private industry initiatives. Such a possibility should not be dismissed. To the extent that the private sector is capable of offering additional insurance coverage, this would add to the strength of the market forces policing banking and the FDIC would of course welcome such a development. However, the FDIC recommends that this be left to the free play of the market, without subsidization from the FDIC.

Increasing the risk of junior creditors -- Enhanced market discipline of banks may be obtained in other ways than by increasing depositor risk. From the standpoint of market discipline, intermediate and long-term subordinated debt affords certain advantages over deposits. Subordinated lenders are apt to be more sophisticated -- more used to evaluating credit risk. Once having made the loan or investment, they generally cannot flee during adversity without incurring some loss. In a sense they have to view the borrower's (bank's) operations from a longer-term prospective. Unlike stockholders, their return is fixed and they generally do not receive any benefit from increased risk. Unlike depositors, they cannot count on being bailed out at the time a bank fails. If and when a bank does fail, subordinated debtors provide a protective cushion to the FDIC between insolvency and FDIC loss.

The fashioning of a proposal wherein junior creditors could play a larger part in applying market discipline to banks is not difficult. It could be done, for example, through administration of capital adequacy standards and might provide for required minimum levels of capital relative to assets, with the designation of a specific portion that could be in subordinated debt. This of course would be a significant step. The FDIC does not recommend this approach at this time, but considers it worthy of serious consideration.

A Summary and Tentative Assessment

In the final analysis, proposals intended to enable the FDIC to fulfill its public interest objectives in a changed financial environment must reflect a judgment on possibilities, rather than certainty as to how best to proceed. Some recommend that nothing be done; that the FDIC await the unfolding of events. The FDIC is convinced that the risks to the system in maintaining the *status quo* are unacceptably high. Its core conclusions and recommendations may be summarized as follows:

1. The success of deposit insurance may be attributed in part to extensive regulation of banks, including constraints on interest payments, powers, and expansion opportunities;

2. The responsibilities of the deposit insurance system are expanding at a time when regulation is contracting, setting up a potentially dangerous situation;

3. Merely to institute new and more extensive supervision and regulation of banks would choke off the present deregulation movement, which carries with it the promise of a more competitive financial system; to attempt to price deposit insurance so as to adequately compensate for new risk that may be assumed by banks seems to be impractical, although a modest step in that direction is recommended;

4. Accordingly, it is appropriate that the private sector assume some modest portion of the risk now borne fully by government. Of the various ways in which this could be accomplished, the most attractive appears to be a modified payoff transaction, combined with better financial disclosure by banks, the institution of a depositor preference statute and possibly some control over deposit brokerage.

Any transfer of risk to the private sector is possibly destabilizing. To a certain extent this is intended and desirable. Banks unable to handle the new opportunities presented by deregulation should not be protected from market discipline. Whether the destabilizing consequences may be too great is a question that will be debated. The potential for massive, systemic problems is far greater, in the FDIC's judgment, if changes along the lines recommended are not implemented.

It will also be asked how, if the FDIC is not capable of instituting a risk-related premium system, can the private sector be expected to evaluate banks properly. The FDIC is, after all, in a far better position to reach judgments on the condition of individual banks because of its better access to information, including examination reports, that is not available to the private sector.

There is some plausibility to this contention. In part the FDIC is suggesting rectifying the situation by improving the flow of information to the private sector through more extensive disclosure. But the question remains and raises more fundamental issues.

The FDIC can continue, and intends to continue, to utilize its supervisory powers to work with individual banks in the solution of problem situations. It will continue to utilize its enforcement powers where cooperation cannot be attained. The FDIC can go further, of course, but then one comes up against the question of who should be making banking decisions and what kind of banking system we desire.

If because of its better access to information about individual banks, the FDIC is compelled to inject itself into bank management to an extensive degree, then we will be approaching a banking system which is essentially government-directed. The market's judgment on occasion may be harsh, but it is the kind of judgment that has served the Nation well over the long run.

The FDIC is not, obviously, suggesting that banking be thrown open to the unrestricted consequences of market driven decisions. What it is suggesting amounts to a modest move toward coresponsibility or coinsurance between the public and private sectors. Under such a program, the FDIC believes that deregulation of the financial system can proceed.

TOWARD A MORE EFFICIENT INSURANCE SYSTEM

Deregulation, current and prospective, has posed some knotty conceptual issues relating primarily to the extent to which responsibility for the safety and soundness of the banking system should be apportioned between government and the private sector. These are the questions addressed thus far, but Congress has posed several others that are of equal importance as the financial system moves into new and unchartered territory: quite apart from the subject of market discipline of banks and the broad role of deposit insurance, just how strong are the insurance funds today; how strong are they likely to be in the future; and does it make any sense to continue to have separate insurance funds for different types of depository institutions? Chapters V and VI in the study address these questions in specific detail.

FDIC Capabilities

The strength of a deposit insurance program is determined by a mixture of elements, many of which are not susceptible to actuarial scrutiny. The known condition of individual banks at any point in time must be weighed against possible swings in public confidence in the banking system in response to unpredictable events; the size of the insurance fund in dollars or in relation to its potential deposit liabilities may seem too large or too small depending upon one's estimate of the future state of the national or world economy. Other illustrations could be given.

Recognizing these unusual characteristics of a deposit insurance system and the impossibility, in any scientific sense, of reaching conclusions as to the adequacy of a deposit insurance fund, it is nonetheless reassuring that the Nation's deposit-insurance system has worked so well over a half century, which includes periods of economic stability, of sharp recession, and of burgeoning inflationary growth. If not to the satisfaction of actuaries, the insurance record does, after all, count for something, and it is laid out in Chapter V. The conclusion is that the income flow and the size of the FDIC's deposit insurance fund, relative to its potential liabilities, are adequate today and should be adequate in the future, always assuming of course that the institutions whose liabilities are insured will receive the proper degree of supervision from the market and/or from government.

Merger of the Deposit Insurance Funds

Congress has asked that the FDIC comment on the "feasibility of consolidating the three insurance funds." The FDIC believes some consolidation is not only feasible but eminently desirable. The qualification "some consolidation" relates only to its belief that the limited role and small size of the typical credit union makes it unnecessary to bring the National Credit Union Share Insurance Fund into a consolidated agency, at least at this time.

The FDIC recommends the consolidation of the FSLIC and the FDIC. There are, of course, long-standing links between insurance and supervision, which make it difficult to treat the merger of the insurance funds in isolation. Accordingly, the FDIC recommends the severance of those links where they are no longer useful or practical, together with a strengthening and a modernization of the regulatory structure where it seems necessary because of the changing financial environment. Specific discussion of these recommendations is provided in Chapter VI of the study. The recommendations themselves may be summarized as follows:

1. The Federal Savings and Loan Insurance Corporation ("FSLIC") and the FDIC should be merged into a new agency or entity, under the direction of the FDIC;

2. The new insurance agency should be separated from the applications process and from all regulatory functions not directly related to safety and soundness;

3. The new insurance agency should have authority to require reports of, conduct examinations of, and take enforcement actions against, all its insured banks and thrifts and their affiliates;

4. A single agency should be established for chartering and regulating all federal banks and thrifts, and for regulating holding companies; such new agency to be separate from the insurance agency; and

5. Greater reliance should be placed on state supervisors for primary supervision and corporate applications from state-chartered depository institutions.

The foregoing recommendations may be divided between those relating directly to the merger of the insurance funds and those which go further to suggest a reorganization of the supervisory and regulatory structure at the federal level. The principal arguments for both sets of recommendations are briefly reviewed below.

Merger of the Insurance Funds

It is difficult to argue that the insurance funds of the FSLIC and the FDIC should be separately maintained when the functions of the thrift institutions and commercial banks are so similar that virtually the only distinction that can now be found in present law between the two types of institutions is in the nature of the insurance attached to the liabilities of each. Not only are the depository institutions involved now almost indistinguishable in the powers they possess, but they are also beginning to come together, in some instances, in larger financial organizations, a trend that doubtless will accelerate in the future.

The deposit insurance funds are similar in many respects, as is described in the study. Possibly more important, the public interest objectives of deposit insurance are identical for the two funds, namely, to protect the Nation against the destabilizing consequences of the failure of depository institutions, and to assure depositors, particularly those least able to sustain losses due to bank failure, that their deposits will be made immediately available.

For those who may desire, for one reason or another, to keep the funds separate, it is always possible to put together a group of technical arguments or to cite difficulties that will be encountered. However, once it is decided to consolidate, solutions are readily available to meet any difficulties. The study provides a variety of options from which a selection might be made. A few items are possibly worth noting here.

The study recommends that the FSLIC be merged into the FDIC. This is not a crucial recommendation; thought could be given to creating a new insurance agency. It is simply more practical to consider utilizing the FDIC as the receiving agency in this case since it already supervises an important body of thrift institutions (mutual savings banks); insures approximately two-thirds of all Federally-insured deposits; is an independent agency rather than simply one of the operating arms of a larger agency, as is the case with the FSLIC; has by far the largest fund and administrative staff; and has the greatest name recognition.

The two deposit insurance funds could be administered separately, or joined. A phase-in program can be instituted to meet transitional problems, if any. Administration of the new agency could be by a board with representation designed to assure that any special interests of existing agencies are met.

The recommendations for change in the supervisory structure are likely to encounter greater debate. Reorganization of the Federal regulatory system has been one of the longest running debates in Washington, surfacing almost immediately after the present structure was put into place in 1933. Moreover, whereas much of the debate in the past centered on simply combining those agencies dealing with banks, today there is no need to exclude from such proposals the Federal Home Loan Bank Board ("FHLBB"), which is chartering and supervising depository institutions with powers virtually identical to those of banks.

Under the approach recommended by the FDIC, certain important changes can be accomplished: (1) the insurance agency would no longer be involved in the applications process or in any other regulatory matters affecting depository institutions except those that relate directly to safety and soundness considerations; (2) the dual or state/federal banking system would be preserved, even strengthened; (3) the chartering agencies would have the primary supervisory responsibilities; the new insurance agency would retain examination authority over all insured institutions but would focus on problem and near-problem institutions, only sampling the sound institutions; (4) provision would be made for Federal Reserve Board ("FRB") representation on the insurance agency board; possibly, depending on the form of reorganization, the FRB could also be represented on the board of the consolidated regulatory agency; and (5) sole responsibility for the resolution of competitive factors in merger and acquisition cases would reside in the Attorney General's office, which is the principal enforcer of the antitrust laws, while the SEC would handle all securities matters and the Federal Trade Commision ("FTC") all consumer compliance matters.

These recommendations would accomplish significant changes. One in particular perhaps deserves further comment: the removal of the FRB from supervisory and regulatory responsibilities, except to the extent that the FRB is represented on the board of the new insurance agency or the board of the consolidated regulatory agency.

The relationship between regulation and the central bank was not a matter of major significance until about 1970. In 1913, the creation of a central bank was intended as a means to extend Federal government supervision to state-chartered banks, most of which were assumed to be receiving little effective supervision. Most state banks, however, elected not to join the FRS. When bank holding company supervision was provided for in 1956 and placed in the FRB, Congress was dealing with only 47 institutions holding approximately 8 percent of all commercial bank deposits. As matters now stand, the FRB is the sole regulatory agency for bank holding companies, which number in excess of 4,000 and represent approximately 85 percent of all bank assets, and the Board continues as the regulator of state-chartered member banks.

The connection between regulation and the central bank has posed two kinds of problems. The first revolves around the question of the appropriateness of combining monetary policy interests with regulatory responsibilities. Perhaps the classic formulation of the issue was by a governor of the FRB (J. L. Robertson) in 1963: "In appraising the soundness of long-term investments, bank examiners should never be obliged to switch from rose-colored glasses to black ones, and back and forth again, in an effort to implement the monetary policy of the moment." To be sure, much depends upon what is meant by "monetary policy," but to the extent that monetary policy is thought to be aided by being able to influence expansion policies of depository institutions, particularly commercial banks, there will be inevitable occasions when monetary policy and regulatory procedures and objectives become thoroughly intermixed.

A second problem also involves a conflict of objectives. It can be argued that regulatory policy on occasion is held hostage to monetary policy objectives. For example, at a time when bold innovative action might be called for in the regulation (or deregulation) of depository institutions, the political side-effects of adopting such a course of action, as possibly affecting the independence of the central bank as a monetary agency, might well, and quite understandably, lead the central bank to defer taking needed regulatory actions.

The FDIC suggests that responsibility for the conduct of monetary policy should be the principal concern of the FRB. This requires that the FRB have sufficient access to information about depository institutions. Representation on the board of the new insurance agency and/or consolidated regulatory agency should satisfy this need; if not, procedures can and should be adopted to assure that the removal of the FRB from direct regulatory authority does not hamper, and indeed may improve, the flow of necessary information to it.

The FDIC recognizes that the proposals set forth in this final section represent sweeping changes for the current system of deposit insurance and supervision. These changes are, however, no less sweeping or dramatic than those taking place in the financial-services industry. The deposit insurance and supervisory framework can no longer afford merely to react to evolutionary change. It must be structured and equipped to deal with the dynamics of the financial-services industry of today and of the future.

CHAPTER I

THE CURRENT SYSTEM OF DEPOSIT INSURANCE AND ITS IMPACT ON THE STRUCTURE AND OPERATIONS OF BANKS

Page

Executive Summary I-1

Introduction I-2

Historical Overview I-2

The Period 1942 - 1972 . . . . I-4

The Period 1972 - Present I-5

The FDIC and Current Banking Structure I-6

CHAPTER I

THE CURRENT SYSTEM OF DEPOSIT INSURANCE AND ITS IMPACT ON THE STRUCTURE AND OPERATIONS OF BANKS

EXECUTIVE SUMMARY

The FDIC was established in a time of financial crisis to restore confidence in the banking system. Most observers agree that the FDIC has experienced extraordinary success in maintaining the stability of banking, and many have argued that it has been too successful. Before Federal deposit insurance became a reality, there were concerns expressed that insurance would effectively remove banks from the discipline of the market. These same concerns have been voiced with increasing frequency to the present time.

Since the FDIC began operations, some portion of failed bank situations have been handled in ways that have provided de facto 100 percent insurance coverage to all depositors and general creditors. In recent years the vehicle used has been the purchase and assumption transaction (P&A), whereby all liabilities of general creditors (including uninsured deposits) are transferred to an assuming bank. Since the early 1960s, most failed insured banks have been handled by the P&A route. Especially in large banks, there probably is the perception among depositors of minimal risk of loss, and therefore there are few incentives to choose between banks based on financial condition.

During the early years of FDIC operations, a lack of market discipline probably was of little significance. Bankers who survived the Depression were extremely cautious. Although the FDIC handled approximately 400 bank failures from 1934 through 1942, risk in the system probably was not great. Most of the banks that failed during this period were small, and the book losses realized by FDIC were minimal.

The same conservative philosophy to some degree was prevalent throughout the next three decades. Banking was changing, but only 110 banks failed from 1942 to 1972. The economy was growing and much of the restrictive legislation passed in the 1930s was still in place.

In more recent years, banking behavior has changed in many respects. In terms of performance, earnings have become more volatile, and loan losses have risen dramatically. Banking markets have become more competitive, and traditional lines of commerce have begun to blur. The economy during this period has been relatively weak, and more unstable. As a result, the banking system has become more risky, and the risk is likely to increase as the process of deregulation intensifies. In a deregulated environment, the existence of market discipline is likely to become more important to a well-functioning financial system.

INTRODUCTION

There is concern today that the Federal deposit insurance system has removed most market restraints on the ability and willingness of bank management to pursue actions that would not be tolerated in a less economically secure environment. This concern is predicated upon several factors. First, since the early 1960s the FDIC has handled most failed and failing bank situations through merger into a stronger institution, which provided _de facto_ 100 percent insurance to all depositors and other general creditors. Until Penn Square Bank failed in mid-1982, no bank with assets of $100 million had been dissolved by way of a payoff of insured deposits. Second, as the powers of banks and bank holding companies expand further and banking markets become more competitive, banks will be under more pressure to maintain profit margins and increase risk-levels. Third, there is considerable evidence that risks in banking already have increased. Increased leverage, primarily at larger banks, and apparent undue concentrations of credit to troubled sectors are often cited as examples.

The purpose of this chapter is to sort through the available evidence to determine the effect of the deposit insurance system on the structure of banking and operating practices of banks. To place recent developments in better perspective, the first section deals with the events preceding the Banking Act of 1933 and chartering of the FDIC, and developments through 1941. The banking environment and FDIC operations during the post-war years through 1972, and from 1972 to the present are then considered, with the final section devoted to a discussion of the current role of Federal deposit insurance and its effects on the current banking structure.

HISTORICAL OVERVIEW

Much of the early history of the U.S. monetary and banking system is characterized by instability and crises. By 1900, however, what was thought to be a relatively stable dual system of state and national banks had evolved. While credit quality problems probably existed, it was generally recognized that one of the major weaknesses of this system was the absence of a vehicle to prevent liquidity crises from developing. A severe panic in 1907 laid the foundation for the creation of the Federal Reserve System in 1913.

Even with a "lender of last resort" in place, liquidity problems persisted. While member banks had access to borrowings from the Federal Reserve Banks, state banks had to rely on correspondents to supply liquidity. For a number of reasons, including the large proportion of small, rural banks in the system and limited communications facilities available at that time, liquidity remained a major problem. Many banks, seeking to accommodate cash demands or increase liquidity, reduced credit extensions and, in some cases, liquidated assets. This had the effect of reducing cash available to the community which, in turn, placed additional cash demands on banks. Banks were forced to further restrict credit and to liquidate assets, thereby depressing asset prices and further exacerbating the liquidity problems. As more banks were unable to meet withdrawals and were closed, depositors became more sensitive to rumors. Bank "runs" became more common.

Although the decade of the 1920s was generally prosperous, an average of about 600 banks per year failed between 1921 and 1929. While most of these were small, rural institutions, depositors lost an aggregate of approximately $560 million (or about 35 percent of deposits in failed banks) during this period, and had a considerably larger amount of funds tied-up in bankruptcy proceedings. As more banks failed, the volume of assets being liquidated became significant. This activity further depressed asset prices, and added to the problems of banks attempting to gain liquidity.

Between the time of the stock market crash in the fall of 1929 and the end of 1933, about 9,000 banks were closed with an aggregate loss to depositors of about $1.3 billion. The banking and financial system had almost collapsed, and both the manufacturing and agricultural sectors were operating at a fraction of capacity.

The FDIC was established within this economic climate to help restore confidence in the banking system.1/ By almost any measure, the FDIC has been extraordinarily successful in maintaining stability of the system: bank "runs" soon became a thing of the past; the money supply, both on a local and national basis, ceased to be subject to contractions because of bank failures; liquidation of failed bank assets no longer disrupted local or national markets; and, a significant proportion of community assets no longer was tied-up in bankruptcy proceedings.

Many observers of FDIC operations believe that the Federal deposit insurance program has been too successful, and has effectively removed the necessity for depositors, and perhaps other general creditors to exercise much discretion in the placement of funds in banks.2/ The literature of the 1930s suggests that these issues were of concern at that time. There was a fear that the complacency of depositors would encourage lax management practices and a general deterioration in credit quality. Additionally, there was concern that deposit insurance would adversely affect the quality of state bank supervision. From its inception, bank examinations have been used by the FDIC to control risks within the system.

1/ Although the FDIC represents the first attempt at Federal deposit insurance, several states had deposit insurance programs in effect prior to 1933. The earliest program was established by New York in 1829. By 1930, there were no state programs in existence. For a comprehensive review of these programs, refer to Appendix G.

2/ This topic is reviewed briefly later in this chapter and discussed in more depth in Chapter III of this study.

The early years of the FDIC's existence were not a period of risk-taking by banks. Bankers who survived the Depression were extremely cautious. Legislation enacted in the 1930s limited bank behavior, essentially to insulate banks from competing with one another too aggressively. Entry was limited by cautious behavior on the part of regulators and by a still depressed economy.

With the exception of the recession years of 1937-1938, the economy expanded throughout the 1930s from the low point reached in 1933. Nevertheless, the FDIC handled approximately 400 bank failures from 1934 through 1942. Most of these were small banks, with the FDIC realizing an aggregate book loss of only about $24 million as a result of these failures. Without the presence of Federal deposit insurance, the number of bank failures undoubtedly would have been greater and the bank population would have been reduced. The presence of deposit insurance also may have limited the necessity for some banks to merge, and may have indirectly encouraged retention of restrictive state branching laws. It had been recognized for some time that a branch banking system potentially was more stable than unit banking because of the ability to geographically diversify the deposit base. As the failure rate began to increase during 1929, many states moved to liberalize branching restrictions; from 1929 to the enactment of the Banking Act of 1935 (authorizing a permanent Federal deposit insurance system), 13 states enacted laws providing broader branching powers for banks. After 1935, it was almost 30 years before any state again liberalized branching. However, limited financial incentives prevailing during most of the 1930s also probably served to reduce bank mergers.

THE PERIOD 1942 - 1972

During World War II, government financial policies and private sector restrictions produced an expanding, very liquid banking system. Bank failures declined significantly (only 28 insured banks failed in the period 1942-1945). Banks emerged from World War II in very liquid condition. Loan losses were practically nonexistent. In fact, many banks experienced sizable recoveries on previously charged off loans.

During the next three decades banking behavior by present standards continued to be very conservative. In general, economic performance was favorable, with recessions reasonably mild and short in duration, and the number of business failures and the volume of loan losses at low levels. This was a period of general prosperity, with a secularly increasing GNP, generally low levels of unemployment and, after the Accord in 1951, a relatively stable price level. Until about 1960, banks continued to operate in an insulated, safe environment. Gradually, banks began to change the way they operated, and some of the restrictions began to be dismantled. The Depression experience ceased to be a dominant force influencing bank management. Still, during the 30 years from 1942 to 1972 there were only 110 failures of FDIC-insured banks, with total book losses aggregating $40 million from the FDIC's beginning through 1972.

It would be an oversimplification to think of this period as being uniform. Banking changed substantially in this 30-year period. Beginning in the early

1960s, some states started to liberalize branching laws. Additionally, the bank holding company vehicle was used increasingly to enter new product markets, and the appearance of negotiable certificates of deposit represented a dramatic shift in bank funding strategy. However, from the standpoint of the FDIC's role and perceived depositor risk, this was a period in which bank failures and their possible occurrence were not very important.

It is difficult to assess the impact of the FDIC on bank structure or the operation of banks with respect to risk. Undoubtedly, the bank examination and supervisory role of the regulatory agencies contributed to the lack of risk in the system during these years. However, a stable economic climate and a vivid memory of the experience of the 1920s and 1930s were contributing factors. On balance, it would be hard to argue that deposit insurance played a dominant role in affecting bank structure in this period.

During this time, there was some concern about how the presence of deposit insurance might limit market discipline. There was occasional discussion about variable-rate premiums, but it was conceded that the 1930s experience might not be relevant, and bank failures and loan losses were too infrequent to provide the bases for any statistical analysis. Whether because of their own conservative behavior, existing legislative constraints or the behavior of bank supervisors, most banks operated during much of this period at a level of risk where market discipline probably did not matter. Indeed, statistical studies relating equity prices to capital ratios and other risk measures suggested that they had not been important or discernible in explaining bank stock prices.

THE PERIOD 1972 - PRESENT

In more recent years banking behavior has changed in many respects. From a performance standpoint, earnings have been more volatile. Loan losses have risen dramatically, and even in some very good years (1977-1978) they never returned to the low 1960s levels. More and more bank funding has involved purchased money, even for moderate sized banks. Demand balances have become relatively less important and, in the case of the household sector, most of these now pay interest. Cheap deposits, in general, have become scarce. Banks have entered new product markets, geographic expansion possibilities have broadened, and traditional banking services are now being offered by some financial conglomerates. Some of these things have developed suddenly while others reflect a regulatory and competitive environment that has been gradually changing.

It is difficult to determine what precisely reflects changing bank behavior and what can be explained by the economic environment. The changing behavior of banks has made the industry more vulnerable to economic conditions. However, in a more stable environment, like that of the 1950s and 1960s, current behavior might not have placed significant strains on the system.

The performance of the economy of the past 10 years has not been very strong. Real growth has been sluggish, averaging approximately 1.4 percent from the first quarter of 1973 through the first quarter of 1983. Recessions have been more severe, and the downturn from which the economy is just emerging is by far the most severe in the post World War II period. Business bankruptcies recently surpassed any level reached prior to the 1930s.

The economy also has been subject to various shocks that have affected banking and business in general. The effects of the rapid increase in oil prices beginning in 1973, and the subsequent role of U.S. banks in recycling petrodollars may continue to be a problem for some time to come. The more recent deflation in oil prices is causing loan problems for banks heavily into certain energy related credits (this is similar to the problems related to real estate development projects in the mid-1970s). High interest rates accompanying the change in Federal Reserve monetary policy that began in October 1979, have precipitated major loan problems in the commercial banking system, and have, in combination with an unduly heavy emphasis on fixed rate, long-term lending, caused more severe problems in the thrift industry.

Bank failures have increased during the past decade and, more dramatically, recently. There is a greater sense of bank exposure and risk of failure that exists not just among those who regulate and follow banks but with the general public as well. As a result, bank depositors and other bank creditors have had reason to be concerned about exposure and the value of deposit insurance. Consequently, the level of insurance coverage and the manner in which failed banks are handled has become very important.

THE FDIC AND CURRENT BANKING STRUCTURE

There is concern that the manner in which the FDIC has handled most bank failures in the past has removed a perception of risk from depositors and other general creditors. Since 1960 about three-fourths of failed commercial banks and, until Penn Square Bank, all failures over $100 million in size have been handled through purchase and assumption transactions (P&As). In P&As all deposits (including uninsured deposits) and other liabilities of general creditors are assumed by a new or existing bank. Thus, despite a bank failure, all depositors and other general creditors are made whole in a P&A. In those cases where the FDIC pays off a bank, depositors are made whole up to the basic insurance limit. Uninsured depositors and other general creditors usually incur some loss, especially when foregone interest is taken into account.3/

The P&A has certain advantages over a payoff. The FDIC generally recovers a premium for the assumed deposits, banking site, etc., that it puts up for bids. Banking services are continued and performing loans of the failed bank are purchased by the acquiring institution. There is minimal disruption to the community, little depositor inconvenience and little risk of any secondary effects on other depository institutions.

3/ The topics of market discipline, handling of failed and failing bank situations, and alternative means of increasing market participation in risk evaluation of banks are analyzed in Chapter III.

The FDIC has been reluctant to pay off a large bank because it would involve a substantial cash outlay and it could tie up substantial depositor claims for a long period of time. As long as the market perceives that the FDIC will not pay off a large bank, these banks are able to acquire deposits on risk-free terms despite their capitalization and loan quality. Risk has been encouraged or at least not restrained by the behavior of uninsured depositors. There is little evidence, at least from any analysis during the past several decades, that depositors have ever played a very important role in influencing bank behavior. However, for reasons already cited, bank risk-exposure has become an important issue and deposit insurance does play an important role.

One area where FDIC insurance has clearly been very important during the past few years relates to failing mutual savings banks. Because of their large portfolios of long-term fixed-rate mortgages and bonds, many mutual savings banks incurred substantial losses and capital depletion when interest rates rose so dramatically in 1980-1982. When these institutions approached book insolvency, the FDIC merged these institutions into others and provided financial assistance. Failures were predictable and came as no surprise to much of the financial community. However, because such a large share of deposits was fully insured it became apparent to most that it would be too disruptive and too expensive to pay off any of these institutions. As a result, deposit outflows in anticipation of failure remained modest.

To some extent this situation (and a similar situation for many S&Ls) was facilitated by the increase in insurance coverage to $100,000 in 1980. This represented a significant departure from previous changes in insurance coverage, which had generally been more modest and more or less in line with growth in money GNP. The increase to $100,000 was not designed to keep pace with inflation. Rather, it recognized that many exposed institutions had sizable amounts of large CDs outstanding. The $100,000 limit facilitated their retaining some of these or replacing them with ceiling-free $100,000 CDs (in 1980 only deposit accounts with balances of $100,000 or more were ceiling-free). This increase in insurance coverage provided a vehicle for smaller or moderate-sized banks to compete for funds in regional markets, or through the use of brokers, in national markets.

In retrospect, the increase in the basic insurance limit to $100,000 has been a mixed blessing. On the one hand, it stabilized deposits in troubled bank situations and, in particular, it facilitated the orderly handling of savings bank problems. On the other hand, it also has facilitated participation of large CDs, so that fully-insured accounts within the system could significantly increase. This could hamper any efforts to place large depositors at risk.

Elsewhere in this study alternative means to impart some semblance of market discipline to the banking industry are explored. Chapter II addresses topics related to the feasibility of providing discipline through use of a risk-related deposit assessment scheme, and Chapter III explores the desirability of various other means to impart discipline by shifting risk to depositors or to subordinated creditors. Chapter IV looks at the role of public disclosure in aiding depositors to make an informed judgment regarding the safety of banks. Chapter V discusses the adequacy of the Federal Deposit Insurance Fund, and Chapter VI recommends merging the Federal Savings and Loan Insurance Fund into it. Finally, Chapter VII analyzes the potential for private sector insurance companies to provide discipline by providing excess deposit insurance coverage.

CHAPTER II

RISK-RELATED INSURANCE PREMIUMS

Page

Executive Summary II-1

Introduction II-2

Merits of Risk-related Premiums II-2

Costs and Tradeoffs II-4

General Approach II-5

Focus of Risk Evaluation II-5

Available Data Sources II-7

CAMEL for Risk Premiums II-8

Proposed Approach II-9

Risk Measurements II-10
    Capital II-10
    Credit Risks II-11
    Interest Rate Risks II-13
    Moral Hazards II-15
    Liquidity II-16

Premium Determination Dates II-16

Appeals Process II-16

Size and Risk II-17

CAMEL and Supervisory Costs II-21

CHAPTER II

RISK-RELATED INSURANCE PREMIUMS

EXECUTIVE SUMMARY

The "ideal system" with premiums tied closely to risk is simply not feasible. Such a system would require the FDIC to be given an extreme amount of authority. Moreover, it would entail unrealistic data requirements and much more advanced risk quantification techniques than are currently imaginable.

Even though the "ideal" is not feasible, the FDIC believes that a lesser system based on reasonably sound measures of risk has merit. Relating premiums to risk would reduce the inequity in the current system whereby low-risk banks subsidize the activities of high-risk banks and discourage excessive risk taking in an environment that is likely to encourage it.

Because so few banks have failed, there is little meaningful empirical evidence to support development of any type of comprehensive risk-based insurance system. A system could be based upon perceptions of risk rather than actuarial evidence but, because banks have no viable alternatives for deposit insurance, the FDIC believes such efforts should proceed cautiously. Therefore the FDIC proposes a program that is very limited in scope but one that should reduce some of the inequity in the current system and also provide the basis upon which to build a more comprehensive system.

The proposed system would have only three risk classes; normal, high, and very high. The vast majority of all banks would fall into the normal risk class. It is envisioned that the maximum premium differential would be the assessment credit. However, to ensure that the premium differentials do not drop to insignificant levels, the FDIC might be given authority to vary the assessment rate to reflect risk.

The proposed plan would focus on credit risk and interest-rate risk as they relate to capital. The latter has been the primary cause in all mutual savings bank failures and the former has been the major cause of most commercial bank failures. This system should be sufficient at the beginning and would be particularly appropriate should there be a merger of the insurance funds.

Credit risk will be measured by the dollar volume of classified assets and interest rate risk will be measured by computing the present value of potential changes in future pretax earnings resulting from a dramatic point change in interest rates.

Finally, the FDIC also seeks authority to alter the present system whereby banks with high-risk CAMEL ratings (i.e., a composite rating of 3 or worse) are not charged for the disproportionate amount of supervisory time and attention they require.

INTRODUCTION

It is feasible to implement a program whereby insurance premiums more closely reflect the risk which insured institutions pose to the insurance fund. There are practical limitations on how accurately risk can be quantified but if approached carefully, a system can be structured that would offer worthwhile advantages over the current system. This chapter describes a program that is very limited in scope but which will reduce some of the inequity in the current system. It will also provide a basis upon which to build a more comprehensive system.

MERITS OF RISK-RELATED PREMIUMS

Federal deposit insurance provides an environment of public confidence for depository institutions to help ensure stability in the Nation's financial system. The word "Federal" implies that insured deposits enjoy a credit quality comparable to risk-free United States Government securities. Insured deposits are less expensive and more reliable than alternative funding sources and clearly are less influenced by the financial strength of the insured institution.

Commercial banks and mutual savings banks pay for insurance as prescribed in Section 7 of the Federal Deposit Insurance Act. They are all assessed at the base rate of 1/12th of one percent of total domestic deposits (after adjustments for transactions in process).[1/] The amount paid by any one institution depends solely upon its deposits and not the risk it poses to the insurance fund.

The fact that the present assessment structure does not consider individual bank risk is an undeniable flaw -- but one that has not caused much concern until fairly recently. Since the 1930s, the level and variation of risk-taking within the banking industry has been very low because it has been closely controlled through regulation and supervision. Bank markets and products have been protected and banks have been sharply limited in the amount of risk-taking in which they can engage. Of no less importance has been a relatively stable and growing economy. Overall, so few banks showed evidence of operating in an unsafe manner that failure risk quantification hardly seemed necessary.

1/ Banks can receive a credit that significantly lowers the assessment rate. The credit amount represents a fixed percent of net assessment income, i.e., the assessment revenues remaining after FDIC operating expenses and allocations for insurance losses. The percent, currently 60 percent, depends upon the size of the insurance fund relative to insured deposits.

The banking industry is still very sound but the incidence of failures has been on an upward trend.[2] During the 20 years preceding 1975, the number of failures averaged only 4.2 per year but this increased to 10 for the period 1975 through 1981. Last year there were 34 commercial bank and eight mutual savings bank failures -- the highest rate since 1940. The rise in failures should not be viewed with alarm. Even last year the 34 failed commercial banks accounted for only 0.13 percent of all domestic deposits held by about 14,400 such banks. Considering the economic and competitive environment, the failure rate is still very low and speaks well to the role of deposit insurance as a stabilizer and the willingness of banks to self-insure through reserves, earnings retention and capital. Nevertheless, economic realities and competitive pressures, and the deregulation they demand, mean banks will be under greater pressure to take risks. The prospect of rising risk-levels and attendant increases in failures enhances the appeal of risk-based premiums.

Academic critics of the current system have argued that the progress of deregulation is limited because premiums do not reflect risk. The proper measurement of risk would in theory allow the complete dismantling of all existing regulations and capital standards. Under the "ideal" system, the insurance fund would be adequately compensated for risk-taking, and insurance could then be raised explicitly to 100 percent (market discipline by uninsured depositors would no longer be necessary) to eliminate any noticeable impact on the economy that a failure might have. However, because deposit insurance on a major scale virtually requires a Government monopoly, pricing premiums to truly reflect risk would place an extreme amount of authority in the hands of the insurer. Moreover, the development of the "ideal" system would require much more advanced measurement techniques than are currently imaginable and access to virtually free and perfect information.[3] Because of these requirements, it is unlikely that the "ideal" system will ever be constructed and therefore some explicit regulation will probably always be necessary. Even if the "ideal" is infeasible however, the FDIC believes that a limited risk-based system should be implemented -- one that relates premiums to reasonably sound measures of risk.

Risk-related premiums would reduce the inequity of the current system whereby high-risk banks pay the same rate as low-risk banks. This becomes increasingly important as insurance losses on failures drive up the effective assessment rate. For 1981 and 1982 the net assessment rate after credit was 0.076 and 0.074, respectively. This compares to an average of 0.036 for the preceding five-year period. Since insurance losses are eventually passed on to insured banks, safely run banks not only pay a higher risk-adjusted rate than precariously run banks but they must also absorb the costs when the risk-takers fail -- and they are failing more frequently.

2/ For the purpose of this chapter, failure refers to any case where FDIC funds were required. Several cases were handled through open bank mergers with FDIC assistance. In a few cases the FDIC provided financial assistance directly to the troubled bank to prevent a failure.

3/ A discussion of the literature on the potential benefits of accurate risk measurement is provided in Appendix A.

Risk-based premiums would also force bank managements to consider the impact of their decisions from the insurer's (or potential creditor's) standpoint. Insured depositors have no reason to be concerned about the safety of their funds and therefore provide no discipline regarding their use. Unfortunately, the problem goes even further. With the evolution of liability management, many larger banks have dramatically increased their reliance on the money markets for funding through such vehicles as large uninsured deposits. Access to these markets eased the funding problems of many banks, but increased reliance on volatile and rate sensitive liabilities also introduced new elements to funding risk. More importantly, though, the suppliers of these funds, who have the potential to provide some discipline, also appear somewhat indifferent to risk in larger banks because of the conviction that the FDIC or some other arm of the Federal government will intervene to prevent them from suffering any loss. The combination of deregulation, little market discipline, and a flat-rate insurance premium, may well cause the incidence of excessive risk-taking to reach an intolerable limit. The development of an insurance system that assesses and charges for risk, as informed creditors might, would help ensure this does not occur.

There are two other issues discussed more fully in other sections of this study that affect the need for risk-related premiums. First, adoption of the FDIC's proposal for risk-sharing by large depositors will reduce the need for risk-based premiums since large depositors will begin to take a more active role in disciplining banks. There would still be inequities depending upon how fully-insured funds are used, but uninsured depositors should help control the overall level of risk-taking. Second, the use of risk-related premiums will facilitate a recommended merger of the Federal deposit insurance funds. Thrifts are highly susceptible to interest rate changes while commercial banks are more likely to suffer from problems in the loan portfolio. To the extent one group perceives another to be much riskier, the resistance to a merger will increase. A premium structure that factors in the risk of each group should help reduce concerns about possible inequities with such a merger.

COSTS AND TRADEOFFS

While risk-related premiums are conceptually appealing, particularly in an environment of deregulation, there are costs and tradeoffs to consider. The supervisory costs necessary to apply risk measurements could be very substantial depending upon the comprehensiveness and precision desired. Some risks, such as "moral hazards," can be evaluated only through onsite examinations. Even if premiums were to be based solely on reported data, onsite verification of reported data will still be necessary.

In addition to increased supervisory costs, a risk-based system could entail an expensive appeals program. The larger the number of risk categories or types of risks measured or the more subjective risk measurements are, the more voluminous appeals could become. Procedures will have to be developed and resources will have to be allocated to process complaints in a consistent manner.

The cost of an incorrect risk evaluation also must be considered. No feasible system will always be right -- the risk will be overestimated in some banks and underestimated in others. Moreover, if disclosure of an FDIC risk-rating occurs, the cost of an error could be much greater than the premium differential. Such information would likely be given very high credibility by depositors.

Finally, it must be recognized that inaccurate risk premiums might also result in some unintended and perhaps undesirable industry behavior. Banks inclined to be risk-takers may seek higher risks in areas not covered by the rating scheme in order to offset higher insurance costs. Moreover, if the system misprices risk, the result could be a less than optimal allocation of bank resources. If premiums are too low, banks may engage in excessive risk-taking and this will limit the extent to which deregulation can proceed. If premium differentials are too high, the FDIC will be overcompensated for incremental risk-taking, and bankers will be improperly discouraged from taking risks. In other words, premiums could become implicit restrictions that obviate efforts to deregulate the banking industry.

GENERAL APPROACH

A less than "ideal" risk-premium system will entail certain costs, but it is the FDIC's view that they are outweighed by the potential benefits. However, these costs do argue for certain features: the system should rely as much as possible on observable characteristics; the measurement techniques should be kept as understandable as possible; and the limitations of the plan should be acknowledged and investors should be encouraged to perform their own analysis. Finally, the standards should be set to minimize the extent to which errors of overpricing risk occur.

It may be impossible to develop a comprehensive risk-based system based on failure experience. So few banks have failed that the actuarial base is very limited and much of it is no longer relevant due to changes in the banking industry and its environment. It is not essential that an FDIC-devised system have statistically proven empirical support, but, recognizing that banks have no viable alternatives for deposit insurance, it should at least embrace concepts that appear reasonable to most knowledgeable parties. Even this will take time. There is no experience to go on and while the literature abounds with discussions about the concept, there has been little analysis of how to quantify risk and even less on how such a system would be implemented.[4]

FOCUS OF RISK EVALUATION

The underlying cause in most bank failures is poor management and the end result is usually exhaustion of capital -- but the means for getting there are different. The 135 failure and assistance cases occurring during the 12-year

---

4/ The literature on risk measurement approaches is briefly reviewed in Appendix B.

period, 1971 through 1982, were reviewed to identify the major causes of failure.[5] All failures of mutual savings banks were attributed to interest-rate risk, which results from maturities and repricing intervals mismatched between assets and liabilities. Most commercial bank failures resulted from a combination of factors. These factors could generally be grouped under credit losses, poor funds management, and fraud and embezzlement. In each case, the factors that played a major role in the bank's failure were identified.

The table below shows how frequently the different types of causes were noted under the column headed "Major." The column shows, for example, that heavy loan losses were noted in 77.4 percent of the cases and that serious liquidity problems were noted in 36.3 percent of the cases. Note that this column would total more than 100 percent reflecting that many banks fail for more than one reason. Because of this, an effort was made to determine the one cause in each case that seemed to be the most important. The frequency distribution using only this one cause for each bank is shown under the column headed "Primary."

TABLE 1

CAUSES OF FAILURE
COMMERCIAL BANK FAILURES 1971-1982
Causes as a Percent of Number of Failures

CAUSES OF FAILURE	1971-1982		1980-1982		1982	
	Major	Primary	Major	Primary	Major	Primary
Credit Quality Losses						
Loans	77.4%	61.3%	82.7%	67.3%	76.5%	55.9%
Insider Loans	36.3%	14.5%	26.9%	9.6%	26.5%	14.7%
Poor Funds Management						
Interest Rate Risk	20.2%	4.8%	19.2%	5.8%	17.6%	8.8%
Liquidity	36.3%	2.4%	30.8%	1.9%	17.6%	2.9%
Fraud and Embezzlement						
Internal	13.7%	11.3%	15.4%	11.5%	17.6%	14.7%
External	7.3%	5.6%	5.8%	3.8%	5.9%	2.9%
Number of Cases (Including Assistance Cases)	124		52		34	

---

[5] This includes 124 commercial banks and eleven mutual savings banks. The commercial banks include four assistance transactions. One bank that failed eleven years after receiving assistance was counted twice. Of the remaining commercial bank cases, only 31 were depositor payoffs and the rest were closed bank purchase and assumption transactions or open bank assisted merger transactions. There were no payoffs of mutual savings banks.

The table shows that loan losses account for most commercial bank failures. Significant losses on insider loans were frequently noted but, interestingly, they were not considered the primary reason for failure in very many cases. Interest-rate risk caused relatively few commercial bank failures but it has become more significant as a primary cause of failure. Liquidity problems were noted in many failure cases. These were situations where banks were unable to generate funds through normal operations or at reasonable costs. Except for a few unusual cases, however, liquidity problems only accelerated, not initiated, the demise of the bank. Usually they reflected mounting concerns by creditors over risk in the borrowing banks. Internal theft does not show up as a significant factor in very many failures, but such diagnosis can be difficult to make, particularly in cases involving losses on insider loans that may have been made under false pretenses. The most frequently noted type of external fraud involved the bank paying on uncollected funds -- usually in a check-kiting scheme. Here again, though, it could not be determined to what extent credit losses resulted from misrepresentations by customers.

Disregarding either national or local economic catastrophe, the major risks faced by a bank today can be summarized as follows: credit risks (potential losses from defaults on debt obligations); interest rate risks (potential deterioration of interest margins from adverse interest rate movements); liquidity risks (potential losses from untimely asset liquidations or abnormally-high interest costs incurred to meet funding requirements); and moral hazard risk (the potential for losses from theft or defalcation). No doubt there are other risks and more will surface as banks move toward new business ventures either directly or through affiliates. These will have to be factored into a risk-rating plan as they show evidence of increased significance. At the beginning, though, focusing on the known major causes of bank failure is appropriate to inaugurate a risk-based system.

AVAILABLE DATA SOURCES

While listing the major risks is not very difficult, measurement is an entirely different matter. There are not sufficient data for rigorous quantification of these risks at this time. The FDIC relies on two major sources of information for risk appraisal and each has its own strengths and weaknesses; bank prepared financial statements, known as Call Reports, and examination findings.

Call Reports include the Report of Condition containing balance sheet data and the Report of Income containing earnings data. These standardized forms are compiled by banks as of periodic reporting dates and then forwarded to the FDIC. The scope and reporting intervals depend upon the size of the bank but all banks file balance sheets each quarter and income reports at least semiannually. This frequency and standardization makes Call Reports particularly useful for assessing industry trends and making peer group comparisons to monitor the performance of individual banks. The major deficiency of these reports concerns the reliability and comprehensiveness of largely unaudited reported data. Certain types of data such as the quality of internal controls are not captured. Moreover, historical cost based accounting does not always portray the current financial condition of a bank. Call Reports may obscure underlying inconsistencies in accounting practice; they also contain errors. These errors usually result from confusion or efforts to minimize preparation time, but sometimes they result from attempts to overstate financial positions. This last type of error would likely increase if premiums were based solely on Call Reports.

Recent steps have been taken to improve the scope and quality of Call data. The reports have been expanded to include valuable information about credit risk and interest rate sensitivity. Moreover, the FDIC has sponsored extensive training seminars to familiarize bankers with the new forms and increased emphasis has been given to examination review of the reasonableness of filed reports. While total reliance cannot be placed on Call Reports, they can be used to evaluate risk and to assign premiums.

The examination report is the most reliable source of information available about a bank's financial condition. It reflects firsthand knowledge of a bank and its competitive environment compiled by highly-skilled and unbiased examiners. It is the only means to evaluate nonreportable attributes such as the quality of management and internal controls. It provides an assessment of risks in assets and liabilities to a degree of accuracy that would probably be impossible to match with a reporting system -- even a substantially expanded one. The examination process has proved to be a very effective means of meshing quantitative and qualitative characteristics to produce a comprehensive assessment of a bank's overall condition. As evidence of this, it is noted that 75 percent of the commercial banks which failed over the last 12 years were rated worse than satisfactory by examiners some two years or more before failure. By comparison, the yearly average for all insured banks rated less than satisfactory during this period was only about ten to 15 percent. Furthermore, the examination process was at least partly responsible for encouraging many of those banks to return to satisfactory risk-levels.

CAMEL FOR RISK PREMIUMS

In view of the effectiveness and reliability of the examination process, it is intuitively appealing to rely on this source for premium determination purposes. Perhaps the simplest approach would be to base premiums on the Uniform Interagency Bank Rating System. Under this system (known as CAMEL) a bank receives a rating of 1 (good) to 5 (bad) for each of five areas -- capital, assets, management, earnings and liquidity -- as well as a composite rating reflecting the examiner's overall assessment. The FDIC has rejected the idea of basing premiums on CAMEL ratings for several reasons:

- The examination process requires the expensive allocation of skilled human resources which places practical limitations on how often and when banks can be examined. CAMEL ratings are assigned during onsite examinations and may not reflect current conditions, since the interval between comprehensive examinations could be as long as three years. Moreover, considerable pressure would be exerted by banks with low ratings for reevaluations before the premium setting date.

- If premiums were based on CAMEL ratings, it might cause a deterioration in the generally open rapport between examiners and bank managements. Most bankers are willing to discuss their problems at an early stage with examiners but there are few, if any, monetary costs involved. They might be less open about potential problems in order to minimize insurance costs. If bankers became less free with their information, the examination process would have to be expanded significantly in order to remain effective. The costs of doing this would be very substantial.

- The CAMEL rating is heavily weighted by subjective factors, but providing examiners this important flexibility means allowing a certain amount of inconsistencies. Moreover, some differences in examination philosophies exist among the regulatory agencies. These differences would probably open up the CAMEL process to considerable controversy. Banks undoubtedly will attempt to compare their scores with other banks in terms of relative earnings and capital ratios. Challenges to ratings will be difficult to defend and the FDIC might eventually be forced to adopt rigid guidelines for assigning CAMEL ratings. The resulting loss of examiner discretion might be detrimental to the reliability of the rating.

Overall the FDIC believes that the use of subjective data gathered during the examination process should be minimized for risk-rating purposes and Call data should be relied on to the extent possible. Both sources should be used initially, and as experience is gained the content as well as the weight given to the information will require modification.

PROPOSED APPROACH

Given the limitations of available data, the FDIC believes the best approach is to first design a narrow scope program that focuses on those characteristics closely linked to failure risk. A basic program could serve the objectives of encouraging positive behavior and reducing some of the obvious inequities in the current system. Moreover, it would represent a first step which would provide experience and initiative for a more comprehensive system over time.

The FDIC proposes a system of risk-related premiums that initially would have only three risk categories: normal, high and very high -- with the vast majority of banks falling into the normal category. In other words, the program would focus primarily on banks that appear to be risk outliers.

The program will consider only credit risks and interest rate risks by using the approach discussed below for relating these risks to capital. For reasons discussed later, moral hazard and liquidity risks cannot be reasonably measured at this time, and thus will not be considered in assigning risk classes.

Until more experience is gained, the FDIC believes the premium differential should be kept fairly small to avoid overpricing risk. The maximum risk premium would probably be limited to the amount of the assessment credit that insured banks would normally receive from the FDIC. Usually, this represents 60 percent of the amount left over from gross assessments after deduction of FDIC operating expenses and insurance losses. Insurance losses have been large the last two years resulting in very small credits, but even in more typical years credit would amount to only about .04 percent of an average bank's assets or less than four percent of operating income before taxes. The loss of the credit should not be an unduly severe penalty on a bank but would provide some incentive for reducing risk. Using the assessment credit minimizes the potential damage on marginal institutions. When industry losses are large, safely run banks step up their contribution to the fund. On the other hand, the continuation of large insurance losses could reduce the size of the credit to where it was viewed with considerable indifference by banks. In order to ensure that a risk-based system does not become meaningless, the FDIC might be given some authority to vary the base assessment rate as well as the assessment credit to reflect failure risks.

While the details of risk measurement are explained in more detail below, the premium differential and risk classification would be along the following lines. Banks assigned to the very high risk class would be those operating with dangerously low capital ratios or those viewed as having both high credit risk and high interest rate risk. Banks in this risk class will forfeit their entire assessment credit. Banks assigned to the high risk class would be those having either high interest rate risk or high credit risk. These banks would forfeit half their assessment credit. All other banks would be in the normal risk class and would receive their entire credit.

RISK MEASUREMENTS

In the proposed approach, a bank's capital position would be the central factor in risk classification. The following sections describe the role of capital and the anticipated methods for relating measures of credit risks and interest rate risk. In addition, moral hazards and liquidity risks, which are not covered by the proposed plan, are discussed in more detail.

Capital

Capital is very important to the FDIC because it provides a protective cushion that reduces the potential exposure to the insurance fund. Capital accounts represent a form of self insurance against failure and as such should be considered in any plan to relate insurance premiums to risk.

Few subjects are more controversial than how capital should be evaluated. The FDIC defines capital essentially as recorded tangible equity and valuation reserves less examination-determined losses. Admittedly other factors are important when measuring capital such as risk-levels, current values of assets and liabilities, and the existence of contingencies or other so called "off balance sheet" items. In some cases, book capital accounts may have no significant relationship to the potential exposure to the fund. Still, the exhaustion of book capital is usually the event that triggers failure. The FDIC is evaluating alternative capital measures but prefers to use the current capital definition until there is agreement upon a better one.

The FDIC's stated position on capital is that a well-run and well-diversified bank should maintain capital accounts equal to at least five percent of total assets. It is recognized, however, that this view is not universally held and that a number of large banks are operating at capital to asset ratios less than five percent. There is a level, though, below which risk of insolvency (*i.e.*, failure) becomes pronounced. This level is not the same for all banks, but to determine it would require very precise means for comprehensively measuring *all* risks. This is simply not possible. Nevertheless, because the proposed plan would attempt to measure risks relative to capital and because there is no clear consensus about capital adequacy, the FDIC is considering an initial benchmark capital ratio of three percent for risk premium purposes *only*. Any bank falling below this level would be viewed as operating with capital so dangerously low that it automatically will be placed in the highest risk category. It should be understood, however, that a threshold of five percent would be more appropriate and that the FDIC would probably raise it to that level over the next few years.

Banks with capital ratios greater than the benchmark-level will be accorded risk-ratings by relating potential risk exposure to their capital accounts. In other words, the smaller the capital accounts, the fewer risks a bank will be able to take without an increase in premiums.

Credit Risks

Given that loans comprise a major portion of the asset structure of most commercial banks and present the greatest credit risk, it is not surprising that excessive loan losses, predominantly on business loans, have caused most commercial bank failures. Excessive loan losses usually reflect poor credit judgment and generally unsound lending and collection practices. In most failure cases, loan losses were attributed to self dealing, speculative lending and the failure to diversify credit risks.

Self-dealing usually manifested itself in insider loans which were discussed earlier. It is worth reemphasizing that most loans to insiders are of very high quality. Nevertheless, they do represent a potential conflict of interest that could inhibit the exercise of prudent credit practices. Speculative lending refers to the making of loans with known high risks with the hope of increasing overall loan yields. Examples of this activity noted in a number of failure cases included loans to speculative real estate ventures or loans outside the bank's normal trade area. Credit diversification refers to the extent the loan portfolio is composed of loans whose performance is influenced by common factors. Often, banks that failed suffered loan losses attributable to a particular group of borrowers or type of business.

Call Reports can be used to monitor credit risks. The reports provide data about a bank's loan loss history, the bank's estimate of the allocation needed to provide for expected losses, and the volume of delinquent and restructured loans. There are limitations on the reliability of Call-based measurements. Banks have different policies regarding when to account for a bad loan — and banks will undoubtedly be tempted to delay loss recognition in order to avoid higher risk premiums. Furthermore, past loan losses do not necessarily reflect the current situation. Moreover, the fact that a loan is delinquent does not mean it has higher than normal risk -- there might be mitigating factors such as the existence of collateral or guarantors; conversely, the fact that a loan is not past due does not mean it is sound.

The examination process provides the most comprehensive review of credit quality because examiners skilled in credit analysis can consider nonreportable factors. However, using examiner classifications to relate credit risks to insurance premiums does present problems that must be addressed. As discussed earlier, communications between examiners and bankers could deteriorate to the detriment of the examination process. Further, inconsistencies in examination intervals and examiner judgments could discredit the entire premium system. One way to reduce inconsistencies would be for the FDIC to conduct at least yearly loan examinations of any insured institution that has or appears to be approaching unacceptable credit risk-levels. The use of FDIC examiners on all loan reviews either independently or in conjunction with other bank regulators would help ensure uniformity. Another step discussed later would be to establish a centralized system for evaluating complaints and appeals from bankers concerning classification decisions. These actions will not eliminate problems with using examination findings but should help to reduce concerns about potential inequities.

At this point, the FDIC would propose using examiner asset classifications both in the determination of capital by subtracting estimated losses and in the overall determination of credit risk. Credit risk would be measured by the dollar volume of assets classified Substandard and one-half of those classified Doubtful (it is presumed that the remaining portion of the doubtful loans and all loss loans will be charged off). When the volume of such assets exceeds 70 percent of capital, credit risk will be considered unacceptably high. Admittedly, the use of 70 percent is judgmental and may change if ongoing research at the FDIC indicates another level would be more appropriate. Regardless, any bank with low quality assets exceeding 70 percent of its adjusted capital would be much more exposed to credit risk than its peers.

While examiner loan evaluations provide the best available means for assessing credit risk, the FDIC is still studying the feasibility of using other information. Analyses conducted so far of banks' reported loan loss experience and examination compiled loan delinquency information indicate that there is a significant correlation with examiner assessments of loan risk. However, efforts to use these data to predict examiner classifications have not yet produced results with an acceptable level of error. In other words, it appears that relying on past loss experience or total loan delinquencies would significantly overstate problems in many banks and understate them in others. Ongoing research, however, will probably yield better results. For example, the new Call Reports will provide more consistent information on loan delinquencies and restructured debt than what is currently compiled on examination files. If loan problems can be predicted with reasonable accuracy, the FDIC would consider relying on Call Reports to assess loan risk. At a minimum, the information would be used to monitor for possible inconsistencies in examination asset classifications.

The FDIC is also evaluating the desirability of collecting new types of objective information to assess credit risks. One area where meaningful information tion is particularly scarce is loan diversification. A bank with a well-diversified loan portfolio is insulated from one source of serious problems. Unfortunately, credit diversification, as important as it is, is difficult to evaluate. The examination process compiles information on concentrations of credit but the definition varies on what constitutes a concentration. Most of the banks that failed due to loan problems were not well diversified, yet relatively few were cited for credit concentrations. The FDIC is considering the feasibility of collecting data on loan balances by industry or subindustry grouping and on the size distribution of loan portfolios. Information on out-of-territory loans may also be valuable. Losses on loans outside the bank's trade area were noted in a significant number of cases. These types of data are already reviewed during the examination process but they are not compiled in a format useful for risk prediction models. One solution would be to include such information on Call Reports, although the reporting burden could be substantial. Another approach would be to collect the information in a consistent format through full or limited scope examinations. This would pose some problems with examination frequencies but would still represent a substantial improvement.

Interest-Rate Risks

Interest-rate risks originate from situations where a bank's assets are more or less sensitive than its liabilities to changes in interest rates. Such imbalances, commonly referred to as interest rate gaps, mean that unanticipated interest rate movements will result in unexpected gains or losses. These risks have become increasingly important in recent years due to high and volatile interest rates and the increased reliance by banks on interest rate sensitive funding sources. Benefits of large amounts of fixed-rate low cost deposits and controlled competition are quickly disappearing. The problems that serious and long-term interest rate mismatches have caused the thrift industry are well known.

Fortunately, many of the potential problems of subjectivity and inconsistency that impede or prohibit measurement of other types of risk are not as severe for interest rate risks. There are a number of ways to measure rate risks. Perhaps the most common methods measure the potential impact of short-term interest rate changes on earnings. These methods focus on short-term gaps such as the asset/liability mismatch in maturities or repricing intervals occurring within a three-month or one-year time frame.

When looking at failure risk, both the magnitude and duration of interest-rate gaps must be considered. It is important to recognize that sustained rises in interest rates can affect earnings for years to come. Some institutions may be taking risks so major that a substantial adverse movement in interest rates would quickly devastate their earnings and threaten their viability. In other institutions, however, it may take several years before the full extent of the damage is realized. Therefore, the FDIC intends to measure interest-rate risk by looking at several time horizons.

The FDIC is now collecting information on interest-rate mismatches in the new Call Reports. These reports show the volumes of most interest sensitive assets and liabilities maturing (or subject to repricing) over a three-, six- and 12-month and five-year period. The FDIC is considering an approach which would estimate the relative impact on capital of a 250 basis point change in interest rates over each of these intervals. This would be done by computing the present value of the cumulative change in earnings over each time horizon and establishing for each a ratio to capital at which risk would be considered unacceptably high. Currently, the following levels are being considered for high risk determination:

Time Horizon	Present Value Impact to Capital (%)
1 year or less	20% or More
5 years	50% or More

Admittedly, these levels are judgmental and research is ongoing to see if others might be more appropriate. However, based on estimates constructed using old Call Reports, there are relatively few commercial banks taking interest rate risks of such magnitudes. Any institution exceeding these parameters would clearly be a risk outlier.

It does appear that a large percentage of mutual savings banks would fail the five-year standard if applied now, and undoubtedly many S&Ls would do the same. This may not be the case by the time a risk program is implemented. Call Reports of mutual savings banks (and other thrifts) need to be revised to collect better data on rate sensitivity. Moreover, time will be needed to evaluate the quality of reported data. In all likelihood, the error rate for the first few reports will be very high; it will take time for banks to become comfortable with the new formats. Probably, it will take two years before the risk measurements can be put in place. By that time, many thrifts should have been able to restructure assets and reduce rate risks. Regardless, risk measurement should be consistent for all insured institutions.

While the new Call Reports provide much improved detail about interest rate sensitivities, risk measurement will still require making a number of major assumptions. First, the reports show only aggregate data for years two through five so the assumption will probably be made that equal amounts mature or are repriced each of those years. Second, the average life of certain deposits, such as passbook savings accounts, will have to be estimated. Currently, a 20 percent yearly runoff is being considered. Third, the discount rate must be approximated to compute the present value of estimated changes in future earnings. Probably a rate tied to three to five-year Treasury obligations will be used. Making assumptions along these lines will undoubtedly distort risk-levels for some institutions. Moreover, even if the potential risk is measured correctly, some banks may be using vehicles such as interest rate futures to hedge or protect themselves against adverse movements. Similarly, some, including those that appear to have no significant rate risk, may be using such vehicles to speculate on interest rates movements. Another problem is that some institutions will take high risks but move to minimize rate risks for reporting dates only.

While relying on Call Reports to measure rate risks will require making certain assumptions that may result in some inaccuracies, they should provide a reasonable means of identifying most high risk takers. If it appears that using the new Call Reports results in an unacceptable error rate, it may be necessary to expand the data collected. Realistically, though, there will always be a need for an onsite examination to control for reporting errors and abuses, and there will need to be an appeals program to hear complaints about inaccurate measurements.

Moral Hazards

Moral hazards include both external and internal hazards. External hazards concern the possibility of dishonest acts committed against a bank and its employees by the general public. Robbery, burglary and forgery are the most common causes for these losses and banks generally control them by maintaining security devices, keeping exposed cash and negotiable securities at a minimum, and maintaining adequate insurance coverage. Internal hazard, which concerns the risk of losses from embezzlements or defalcations and other unethical practices, such as using imprudent standards for insider loans, generally poses a far greater threat to a bank's solvency than external hazards. Protection requires clear records and effective internal controls supplemented by fidelity coverage.

It is virtually impossible to evaluate moral hazards without visiting a bank and then using a fair amount of subjectivity. Internal controls and adherence to them must be evaluated onsite. Information could be collected on the volume of insider loans to measure the potential exposure arising from conflicts of interest. Evaluating the risk requires reviewing the credit quality of the loans because often such loans are among the best in a bank.

Risk premiums, in and of themselves, are not likely to discourage dishonest intentions; however, they could be used to induce banks to maintain an effective program of internal controls. Premiums might be tied to the quality of risk controls or to the credit quality of insider loans, but whether or not this could be done fairly and consistently is not clear and will require further study. The FDIC's view at this time is that, while conceptually desirable, relating moral hazards to risk premiums is not feasible.

Liquidity

Liquidity is an elusive concept even though poor liquidity was noted in a significant number of failure cases. Interestingly, liquidity problems have been noted with decreasing frequency -- for example, such problems were noted in about 40 percent of the cases occurring during 1971 through 1979 but only 31 percent of those occurring over the last three years. This probably reflects the increased availability of funding from other than traditional deposit sources, the phasing out of Regulation Q, and perhaps increased stability of the deposit base through increases in deposit insurance limits. Banks may not need to maintain the same levels of liquidity they did in prior years, but reliance on large and potentially volatile liabilities increases the need to consider liquidity in asset management. Most of the failure cases where liquidity problems were noted involved a high reliance on borrowings or volatile deposits coupled with a deterioration in asset quality.

There are a number of important variables to consider when evaluating liquidity; the credit quality and marketability of assets, the dependence on potentially volatile deposits to fund loans, and the strength of earnings. There has been some success in relating these variables to examiners' assessments of liquidity, but the feasibility of combining these factors for premium determination purposes is still uncertain.

PREMIUM DETERMINATION DATES

Risk classification would be determined yearly for all banks as of December 31. The bases would be the year-end Call Reports and the most recent examination report. Call Reports will be used for capital and interest risk computations and examination reports for credit risk and adjustments to capital. To ensure consistency each bank would have the option of submitting a year-end status report on the total amounts of Substandard, Doubtful or Loss classifications that have either been charged off or collected since the last examination. These reports will be used to compute year-end risk ratings and will be verified at subsequent examinations. This should not impose a significant burden on the banking industry since only those banks with a high risk ratings would need to file and only then when it would move them to a lower risk category.

There may be some question about the fairness of using examination data because some banks are examined more frequently than others. It is true that riskier banks are examined more frequently because of the greater need to monitor risk. On the other hand, these banks will have more opportunities to show improvement and reduce their premiums. The FDIC believes all banks in the high risk classes should be examined at least yearly and that limited scope examinations should be conducted annually to monitor risks in banks that appear to be approaching high risk thresholds.

APPEALS PROCESS

It is likely that many banks receiving a high risk designation will seek to appeal. The FDIC believes they should have that right because both Call and examination data have their limitations; assumptions made to compute interest-rate risk or examiner error may result in significantly overstated risks in some banks.

Appeals might be processed in the following manner. Requests for reclassification would go first to the regional offices of the appropriate banking agency. However, to ensure consistency, the final decision would be made at the FDIC Washington Office. Regions would be given the authority to reduce risk-ratings in situations where review indicates examiner error.

SIZE AND RISK

A sensitive issue in any risk-rating plan is whether the same standards should apply to all banks regardless of size. This becomes very controversial if, as the FDIC believes it should, the plan factors in capital ratios. Large banks typically are much more leveraged than small banks, which means they have a proportionally smaller cushion to absorb losses. Still, even though their capital ratios are higher, it is often argued that small banks have comparatively more failure risk. Smaller banks are more likely to be controlled by a small number of owners who have more freedom (i.e., less accountability) to engage in self-serving practices. Small banks may be less able to implement a strong system of internal controls and thus may be more vulnerable to fraud and embezzlement. They also may be less able to diversify credit risk since their customer base is usually smaller and more homogenous, and more loans are likely to be large relative to capital. Finally, the absolute dollar amount needed to cause failure is relatively small and easier to lose for whatever reason.

The table below shows the distribution of commercial bank failure cases by size deciles over the last 12 years. The size deciles refer to the commercial banking industry for commercial bank failures.

TABLE 2

SIZE OF FAILED COMMERCIAL BANKS 1971-1982
Size Decile at Time of Failure

Size Decile	Commercial Banks* Number	Commercial Banks* Percent
1 (Smallest)	29	23.4%
2	18	14.5%
3	13	10.5%
4	11	8.9%
5	10	8.1%
6	9	7.3%
7	6	4.8%
8	5	4.0%
9	2	1.6%
10 (Largest)	21	16.9%
	124	100.0%

*Including Assistance Cases.

In order to allow for the effects of growth over a long period, the relative size of failures over the last 12 years was evaluated by determining the size percentile in which each bank was when it failed. Banks that were among the smallest ten percent in the industry were allocated to the first decile; those falling in the tenth to the twentieth percentiles were put in the second decile and so on up to the tenth decile for the largest banks.

There does appear to be a relationship between size and failure risk. The number of failures clearly decreases moving from the first to the ninth percentile. However, the large number of failures (including assistance cases) in the tenth decile appears to contradict arguments that larger banks are inherently safer. Commercial banks in the tenth decile had assets greater than $100 million in terms of 1982 dollars. Five of these were within the two highest percentiles when they failed, with inflation adjusted assets over $1 billion each. The two largest failures had assets of over $5 billion in 1982 dollars. All of the banks in the tenth decile were large enough to have diversified credit risks and to have adopted strong internal controls and policies.

The reasons for failure are compared among different size deciles in Table 3. Loan losses were the most important factor for all size groups although the frequency with which they cause failure appears to decline as the size groups increase. Again, the notable exception to this trend is the tenth decile. The relatively high incidence rate of credit problems in the large banks appears to mean that even if large banks are more able to diversify, some do not. The incidence of insider loan losses does not appear to follow any particular pattern. Larger banks are also susceptible to losses arising out of insider abuse and conflicts of interest. There does appear to be some merit to the argument that very large banks can better handle risks of thefts or embezzlements. Below the tenth decile there is no obvious pattern to these types of "moral hazards."

Interestingly, liquidity and interest rate sensitivity problems appear more common in large bank failures and suggest that the competitiveness of large bank markets may make such banks more susceptible to funds-management risks. Larger banks rely more heavily on noncore deposits than smaller banks. When things start to go bad (i.e., interest rates turn up sharply or assets turn sour) this source of funds is usually the first to dry up. Presumably this negative reaction by uninsured depositors and creditors is a danger for all banks, even the very largest. However, no bank larger than $10 billion has ever failed or needed assistance, and it may be that in very large banks this risk is less severe. This observation relates to the market discipline issue addressed elsewhere in the insurance study.

There may be other factors to explain the apparent relationship between size and failure risk. Almost half of the failures were new banks, i.e., established less than five years, or banks taken over by new management within the five years preceding failure. By comparison, the average number of banks

TABLE 3

CAUSES OF FAILURE BY SIZE
COMMERCIAL BANK FAILURES 1971-1982
Size Decile at Time of Failure

CAUSE	SIZE DECILE 1(Small) Major	1(Small) Primary	2-3 Major	2-3 Primary	4-5 Major	4-5 Primary	6-7 Major	6-7 Primary	8-9 Major	8-9 Primary	10(Large) Major	10(Large) Primary
Loans	83%	66%	77%	65%	81%	62%	60%	47%	57%	43%	86%	66%
Insider Loans	31	10	26	10	38	19	67	27	43	29	33	10
Rate Sensitivity	14	0	10	3	24	9	13	0	14	0	48	14
Liquidity	35	0	36	3	24	0	33	0	29	0	57	10
Internal	17	17	19	13	5	5	20	13	29	28	0	0
External	7	7	10	6	5	5	13	13	14	0	0	0
Proof		100		100		100		100.0		100		100
Number of Cases (Including Assistance Cases)		29		31		21		15		7		21

NOTE: Causes are shown as a percent of the number of failures for each size group. Major refers to all causes noted in each failure. Since most banks fail for more than one reason, the total of the "Major" column exceeds 100 percent. Primary refers to the one cause in each case that seemed most important.

meeting these criteria amounted to only about one-third of all insured banks. In effect, a little more than one-third of the industry accounts for almost half the bank failures. This disproportionately high ratio suggests that these banks have a significantly higher likelihood of failing than other banks.[7]

The majority of the failures that involved new banks or new management were small commercial banks. Table 4 shows the number of such cases for the failures occurring over the last 12 years broken down by size decile.

TABLE 4

SIZE OF COMMERCIAL BANK FAILURES 1971-1982
Size Decile at Time of Failure

Size Decile	New Bank*		New Ownership*		All Other		All Banks*	
	No.	%	No.	%	No.	%	No.	%
1 (Smallest)	6	40	15	37	8	12	29	23
2	3	20	6	15	9	13	18	15
3	1	7	2	5	10	14	13	10
4	1	7	3	8	7	10	11	9
5	2	13	2	5	6	9	10	8
6	-	-	3	8	6	9	9	7
7	-	-	3	8	3	4	6	5
8	1	7	2	5	2	3	5	4
9	-	-	1	2	1	4	2	2
10 (Largest)	1	7	3	8	17	25	21	17
Total	15	100	40	100	69	100	124	100

*Including Assistance Cases.
Note: Percent totals may not add due to rounding.

---

[7] Approximately 12 percent of the failures were new banks compared to an industry yearly average of 8 percent; approximately 37 percent of the failures experienced control changes compared to an industry estimate of 28 percent which was based on available figures for nonmember banks. Thus it appears 36 percent (8 percent + 28 percent) of the industry accounted for 49 percent (12 percent + 37 percent) of the failures and the remaining 64 percent of the industry accounted for 51 percent. This suggests the failure incidence rate is 71 percent higher for new or control change banks ((49/36) - (51/64)).

The table shows that the apparent relationship between size and failure risk diminishes significantly when considering only the size distribution for all failures other than new banks or banks with new ownership.[8] On balance, it is not clear that smaller banks with established track records are significantly riskier than larger banks, and relating premiums to the size of a bank does not seem appropriate. Rather than use size as a proxy for risk, it is preferable to focus directly on the risk source. However, there does appear to be merit to using more conservative risk standards for newly-established banks and possibly ones recently taken over by managements without established track records. One problem, though, is to establish standards that do not pose undesirable entry barriers to the industry. This matter will require further study.

CAMEL AND SUPERVISORY COSTS

CAMEL ratings, for reasons discussed previously, are not considered appropriate for risk premium determination. Nevertheless, they clearly influence the level of supervisory effort allocated to an individual bank. Banks with ratings worse than 2 usually require more detailed and more frequent examinations. Moreover, other costs are incurred relating to closer offsite review or costs in preparing legal documents. Supervisory administrative costs are borne by all banks, but the FDIC believes that the additional costs incurred when a bank receives a high risk-rating should be borne by that bank. The FDIC recommends that it be allowed to charge any banks with a composite CAMEL rating of 3 or worse for these additional supervisory costs. This would not only serve the interest of fairness by reducing the cost to well run banks but would most certainly provide an incentive for others to improve.

8/ It is not known, however, to what extent failure can be attributed to new ownership. In some cases, banks already in distress were purchased by investors hopeful of salvaging them.

CHAPTER III

MARKET DISCIPLINE AND THE FEDERAL DEPOSIT INSURANCE SYSTEM

Page

Executive Summary III-1

Introduction III-4

Risk Sharing and Insurance Protection III-4
    Modified Payoff III-4
    Coinsurance III-6

Capital Standards III-7

Depositor Preference III-9

Administrative and Operational Considerations III-10

CHAPTER III

MARKET DISCIPLINE AND THE FEDERAL DEPOSIT INSURANCE SYSTEM

EXECUTIVE SUMMARY

The present level of insurance coverage and the manner in which most bank failures are handled have created a situation where most banks' exposure to market discipline is greatly diminished. Consequently, the FDIC believes risk-taking by banks is not sufficiently restrained. Several alternatives are suggested to significantly improve market discipline.

Among those who have followed FDIC behavior in recent years there has been a general perception that the FDIC would not pay off a large bank -- at least not one with assets of several billion dollars. While the FDIC has used a "cost test" to determine whether to use a purchase and assumption ("P&A") or a payout, close decisions involving larger banks have invariably resulted in the choice of the former because they are easier to implement (operationally), are less disruptive and are less likely to threaten the survival of other banks.

The widespread use of the P&A approach has clearly resulted in a number of positive public benefits; however, some less desirable consequences have evolved. In practice, the FDIC has effectively provided large depositors in large banks with a much greater degree of insurance protection against loss than has been provided to large depositors in relatively small banks. Even focusing only upon small banks, the FDIC's choice between assisted deposit assumption and payoff can result in uncertainty and inequity for large depositors. In the case of a P&A, the large depositor suffers no loss or disruption; in a payoff, the losses can be quite large and potentially damaging. This "gamble" on the choice of supervisory approach and the significant disparity of outcome is of concern.

As the use of assisted deposit assumptions has become more common and increased numbers of depositors and investors continue to be shielded from losses in large banking organizations, the public's perception of the relative safety of funds appears to have become altered. Many believe that no large American bank will be paid off even if it were allowed to fail, and have acted accordingly. In addition to driving large depositors from smaller to larger banks, this growing perception of almost absolute safety of funds in large institutions is having the effect of removing the consideration of bank risk from business decisions. As funds placement becomes a more yield-driven choice and one which is less impacted by bank risk evaluation, there is a resultant erosion of the normal forces of market discipline.

The FDIC has not been in a position to pay off a very large bank in a relatively short period of time. The sheer mechanics of balancing a large number of accounts, handling offsets, and determining precise insurance coverage would probably take one to two months for a multibillion dollar bank. Some of the problems could be lessened by keeping bank offices open to pay off insured deposits by setting up a Deposit Insurance National Bank. But there are other, potentially more serious, problems.

The traditional manner of paying off a large bank requires a substantial cash outlay by the FDIC. Thus, a single bank failure could tie up a large share of the assets of the deposit insurance fund and materially undermine confidence in the FDIC. A more serious consequence arises because a payoff would tie up a substantial volume of financial claims and, very likely, there would be severe repercussions in financial markets. Large depositors and other general creditors would have to wait for a long time, probably several years, before they received a substantial share of their funds even though their ultimate dollar loss might be small.

If it is true that the FDIC will not pay off a large bank, then uninsured depositors and other general creditors are not at risk if they confine their "exposure" to large banks. Many uninsured depositors are not particularly familiar with FDIC procedures and have little understanding of their potential exposure (that is borne out from interviews with large depositors, including those who had potential exposure in banks that were closed). However, many bank analysts and financial advisors are sufficiently familiar with FDIC history and attitudes to conclude that there is practically no general creditor risk in large banks. Assuming this is reflected in depositor behavior, the likely impact on banking will be that depositors with large amounts at risk are likely to favor large banks. Large banks, moreover, are apt to have an edge in competing for certificates of deposit ("CDs") in national markets even where moderate-sized (though not fully-insured) deposits are involved because they generally will be able to buy funds cheaper than smaller banks.

Large banks are not the only beneficiaries of the present insurance system and the manner in which bank failures are handled. In the case of most smaller banks, a very large percentage of deposits is fully-insured. Most retail deposits are in accounts of less than $100,000, and by the use of joint accounts and those held in different capacities, that figure can expand several times. Business depositors frequently have outstanding loan balances that can be off-set against deposits not covered by insurance in the event of a payoff so that they have little actual exposure. Recently, brokers have provided a source of funding for banks whereby larger time accounts are participated to a large number of banks in $100,000 lots to provide full insurance for CD customers desiring to invest up to several million dollars. This provides the smaller bank with access to regional or national deposit markets for the price of a moderate commission. The investor receives a higher rate and the spread between CD rates at large and small institutions is narrowed.

As a result of these phenomena, few depositors are exposed to any risk and have reason to be concerned about the financial condition of their banks. When banks fail, stockholders and, in some instances, subordinated creditors lose their investment. However, losses to depositors have been infrequent and relatively small. Because most bank funding derives from sources that are not exposed to loss in the event of failure, banks may be insulated from the effects of increased risk. Their behavior is not constrained significantly by the behavior of their principal creditors. This is in contrast with the risk-restraining role that creditors (including banks) exert upon other private enterprises.

The absence of creditor restraint has probably existed within the banking system for quite some time. Recently, however, its importance has been increasing for several reasons. Bank leverage, particularly at large institutions, has been increasing for years. Interest ceilings on deposits are being dismantled. Banking organizations are expanding into new activities, in response to inroads by nonbank competitors, and into new locations. These forces have all contributed to a more risk-intensive, less-constrained environment which is likely to be less forgiving of faulty financial and credit judgments.

The economic environment has also presented difficulties for banks. Interest rates have fluctuated substantially causing extreme problems for some banks and thrifts and their customers. The severity of the recent U.S. recession has also had a major impact on loan losses, increasing the number of problem banks and bank failures. Some of these factors and others have contributed to substantial U.S. bank exposure in their overseas lending. Thus, while the absence of significant depositor restraint on bank behavior may not be a new phenomenon, its importance appears to be much greater today than during any time in the past.

There are several possible ways in which the absence of sufficient market restraint on bank risk might be successfully addressed. First, a system of risk-related insurance premiums could be adopted, as recommended in Chapter II, so as to appropriately reflect and compensate for the level of risk exposure in a particular institution. However, while the FDIC favors a risk-related premium system, it does not believe that risk can be measured precisely enough to set insurance premiums to entirely compensate for the level of risk exposure in a particular institution.

Thus, the FDIC recommends adoption of procedures that would result in reduction in the de facto level of insurance protection for "uninsured" depositors and general creditors. By introducing an element of loss-sharing, large creditors and investors would be more risk-sensitive and more selective in their choice of banks; therefore, market discipline could be increased significantly. In addition, or perhaps alternately, it may be appropriate to look increasingly to bank stockholders and subordinated noteholders to supply this discipline through a larger "capital" cushion composed of equity and subordinated debt. This chapter focuses upon these issues and other related topics.

INTRODUCTION

Federal deposit insurance has worked well to limit the secondary effects of bank failures and to increase the public's confidence in the banking system. Insured depositors have not had to concern themselves with the condition or safety of their depository institutions. However, because of the manner in which the FDIC has handled most bank failures, most uninsured depositors have not had to concern themselves with the condition of their bank either.

During the past 20 years, the majority of bank failures and practically all larger bank failures have been handled through purchase and assumption transactions ("P&A"). In such transactions, all deposits and other nonsubordinated liabilities of the failed bank are assumed by another (existing or new) institution. As a result, no general creditor incurs any loss despite the closing of a bank. On a few occasions the FDIC has provided direct financial assistance to open banks that would otherwise have failed and has provided direct assistance to facilitate open-bank mergers of failing savings banks. These transactions, like P&As, make all depositors "whole."

By contrast, in a payout the FDIC settles only insured depositor claims up to the statutory limit. The assets of the failed bank are transferred to a receiver, and the depositors who had in excess of $100,000 have a claim on the receivership for the uninsured portion of their deposit. They share *pro rata* on receivership recoveries with the FDIC (standing in place of insured depositors) and other general creditors of the failed bank. In most payouts uninsured depositors incur some loss, particularly when their foregone interest is factored into the calculation. A majority of payouts have involved situations where, because of restrictions on bank expansion or other factors, there were no interested bidders or where there was fraud and uncertainty about unbooked liabilities or other contingencies that made it impossible to make reasonable estimates of the costs involved.[1/]

RISK-SHARING AND INSURANCE PROTECTION

Modified Payoff

The main problem with a bank payoff, especially in the case of a large institution, is that a potentially large volume of assets and uninsured creditor claims can be frozen in bankruptcy proceedings for a long period of time. There is a means available whereby a substantial volume of funds can be made available to bank depositors and creditors in a short period of time, while exposing uninsured depositors and senior creditors to some risk of loss. This

---

[1/] Prior to the failure of Penn Square Bank in 1982, the banks paid off by the FDIC since 1960 had average deposits of less than $8 million, with the largest payout being Sharpstown State Bank (about $60 million) where there were large potential claims related to lawsuits over securities violations.

approach would not require enabling legislation and would entail the increased use of the bank payoff option, coupled with many of the advantages of a P&A transaction.

Upon a bank's closing and the establishment of a receivership, the FDIC (in its corporate capacity as insurer) could take two actions. First, insured-depositor claims would be satisfied as rapidly as possible as is the current payoff practice. Second, an "advance" of additional funds to all remaining valid claimants would be made, equivalent to the FDIC's estimate of the total value of bank assets to be recovered in liquidation.

It is envisioned that the insured-deposit settlement and the additional "advance" of other funds could generally be facilitated by transfer to an operating institution (partial assumption of liabilities) or by transfer to a newly-chartered interim bank. This would serve to lessen the public disruption by making funds readily available and should preserve some of the "goodwill" value of the failed bank when coupled with a limited purchase of assets.

The amount of the "advance" would vary on a case-by-case basis and would be calculated on a percentage formula (ranging from zero to 100 percent). The percentage chosen would be estimated by the FDIC based upon the anticipated total value of liquidating dividends which would ordinarily have been distributed to general creditors after an orderly liquidation. This sum would be made available to all valid general creditors to meet their liquidity needs and to ease the impact of the bank closing. Receivership certificates would be issued for all remaining claims.

In some instances the net realized asset value from a bank liquidation would be less than the sums initially advanced by the FDIC fund. Unless the FDIC's initial estimates prove to be significantly in error, this amount should be relatively low. The most practical response would be for the FDIC to forego an attempt to subsequently recover this sum and to simply allow the insurance fund to bear the modest additional expense. If the net realized asset value exceeds the amount of the original advance, this amount would be distributed on a pro rata basis to the holders of receivership certificates.

From the FDIC's perspective, the advantages lie in the flexibility of this approach and in the potential for increasing creditor discipline. The drawbacks lie in the operational and administrative complexity and the possibility of public dissatisfaction with the FDIC's initial estimates of loss. From the perspective of conserving the deposit insurance fund and because of uncertainty, some might assume that there could be a tendency to underestimate probable net recovery.

While legislation would facilitate the modified payoff approach, the FDIC can begin to use this approach without Congressional action. This would allow experimentation to determine whether the policy seems to bring about desired results and to determine whether there are latent downside risks. It would provide an opportunity to learn from experience without giving up options and locking the FDIC into a program that could not be easily revised.

Coinsurance

A variation of the modified payoff approach is to statutorily mandate a coinsurance provision. For example, deposit balances up to some basic insurance limit (say, $100,000) would be fully insured, with deposit balances above this limit subject to 75 percent coverage (*i.e.*, the depositor provides "coinsurance" on 25 percent of the excess balances). The workings of this system are basically the same as the modified payoff alternative discussed above, except that nondeposit general creditors will not be covered, and depositors will know the proportion of uninsured funds that will be immediately available if the bank should fail.

The major advantages of the coinsurance option compared with the straight modified payout approach are: (1) it eliminates the uncertainty and possible controversy associated with making an estimate and the ultimate recovery in receivership assets; and (2) it provides uninsured depositors with assurance they will receive a relatively high proportion of their funds, thereby lessening the possibility of adverse market reaction.

The arguments against both of these proposals fall into three groupings. First, they may not have much impact. Smaller banks and thrifts already are so very heavily insured that it would have only a modest effect on them. For intermediate-sized to regional banks, it is argued, CD brokers will expand their activities so that these banks will greatly increase their insured deposits, resulting in very little depositor risk exposure. It is extremely difficult to gauge the market potential for brokering large CDs. Certainly the Penn Square Bank failure stimulated the expansion of this market and the perception of more general depositor exposure could bring in new firms, expand advertising and dramatically increase the size of the market. It is also argued that until a multibillion dollar institution is actually closed, that possibility would have limited credibility so that the effect of implementing the proposal might actually be to increase the advantage of the very large bank.

A second set of arguments, directly counter to the first, is that implementing such a proposal will expose the banking system to too much risk and uncertainty. It is argued that depositors will not base their response to the increased risk through cautious, studied analysis of banks. Because deposits can flee quickly and because depositors have little incentive to stay with banks exposed to adverse publicity, deposit flights may be significant and destabilizing. As a result liquidity crises and failures may be precipitated too easily, even under marginal circumstances. Banks experiencing moderate but well-reported problems could be denied the opportunity to recover. Even with Federal Reserve funding, damage to deposit relationships obtained at greater cost and promotional effort, perhaps would be difficult to repair.

Finally, it is argued, implementation could lead to overly conservative banking practices. If the market responds to the perception of bank risk, banks may be forced to react by pursuing cautious loan, capital and expansion policies. This could adversely affect the provision of banking services, innovation, and the financing of a growing economy.

CAPITAL STANDARDS

Economic and financial events of the past several years have demonstrated that a sound net worth position is the only true measure of a firm's ability to withstand protracted adversity and uncertainty. This is particularly true in the case of depository institutions. To the extent that deregulation increases uncertainty, the need for a strong capital base in financial institutions takes on even greater significance. Although subordinated debt is not considered by the FDIC in evaluating the adequacy of capital in a bank (because it is not available to absorb losses in a going concern), subordinated debt does have utility as a funding source for financial institutions and importance to an insurer and uninsured creditor as it provides an additional cushion in the event of failure. Importantly, to the extent the debt is rated and priced to reflect financial risk, it can be a mechanism for imposing market discipline. In this vein, an argument can be made that it would be desirable for every financial institution to have a minimum amount of subordinated debt in its liability structure.

It may be desirable to look increasingly to stockholders and subordinated creditors for the application of market discipline to banks. Bank stockholders typically lose their investment when a bank fails, and this is frequently the case for subordinated creditors where they are present.

From the standpoint of market discipline, subordinated debt affords certain advantages over deposits. Subordinated lenders are apt to be more sophisticated -- and comfortable in evaluating credit risk. Whereas most uninsured deposits mature within a few months or can be withdrawn on demand, subordinated lenders typically are in a very different situation. Once having made the loan or investment, they generally cannot flee during adversity. They have to view borrower (bank) operations from a longer-term perspective. Unlike stockholders, their return is fixed and they generally do not receive any benefit from increased risk. Unlike depositors, they cannot count on the probability of being completely protected at the time a bank fails. If and when a bank does fail, subordinated note holders provide a protective cushion to the FDIC and other general creditors.

Banks could be required to maintain a minimum protective cushion to support deposits (such as ten percent) which could be met by the use of a combination of equity and subordinated debt.[2] Bank regulators, however, might still require some minimum ratio of equity to deposits, perhaps five percent. Smaller banks that already have a high equity ratio or might have limited access to debt markets might choose a higher proportion of equity to meet the ten percent minimum. Larger banks that are well-rated might be able to obtain as much as one-half of this cushion from debt markets in the form of subordinated funding. As banks grow they would be required to add proportionally to their "capitalization". Those heavily dependent on debt would have to go to the market frequently to expand their cushion and to refinance maturing issues. Thus, they would be exposed periodically to the results of their performance and, possibly, to the reactions of rating services.

---

[2] Such a requirement would need to be phased-in over a reasonable time frame to permit the financial markets and the banking system an appropriate adjustment period.

Depositors would be significantly insulated because of the increased size of the protective cushion. Yields on bond issues traded in the secondary market would also provide them with information on the market's valuation of their institution. Large institutions with good internal controls and audits and a reasonable degree of agency monitoring should provide a sufficient cushion so that depositor loss would not occur frequently, even when banks fail.

For this system to work, it would be necessary to enforce such minimum capital requirements rigorously. Penalties would have to be imposed when banks fall below minimum levels. There are a number of details that would have to be resolved under this general scheme and many areas where market adjustments may be difficult to anticipate. Many banks currently are far below suggested cushion levels. There would have to be an appropriate transition period if this proposal were implemented.

Banks facing difficulty will undoubtedly have trouble increasing their capital or debt levels. Some might be forced to seek mergers.

Exactly what qualifies for subordinate notes will have to be worked through rationally. There may have to be limits placed on acceptable default provisions, and acceleration of maturities cannot be allowed. Provisions where debtholders receive some equity interest and exercise some management control such as in the selection of members of the board of directors, however, may be quite appropriate as may convertability to common stock under some circumstances. Maturity selection should take into consideration the desirability of frequent exposure to market judgment. The total debt perhaps should mature serially (such as one-third every two years).

It is difficult to estimate how much debt relative to equity the market will deem to be appropriate and at what interest rate. Even if the cost is moderately high, this will not necessarily have a significant adverse effect on earnings. Suppose, for example, a bank has to pay two percent more for its borrowing than it earns on the proceeds of the acquired funds (a fairly high cost). Even if the bank borrows five percent of its assets, its cost would be .05 x .02 or 10 basis points, before tax, on assets.

The capital markets' ability to supply the "new" equity/debt must be considered. If the funding is mostly debt or preferred stock, there will be a need for pension funds, insurance companies and others to be willing to hold the debt. From the standpoint of making demands on the economy's "savings," that is not necessarily an issue. Funds would be transferred from others into banks which, in turn, will have these same funds to lend out. Some limitations, apart from existing single borrower limits and direct reciprocity arrangements, may be necessary to address the issue of banks acquiring the debt of other banks. Given reasonable safeguards along these lines, interbank transactions should not pose serious problems as long as reasonable equity standards were maintained.

There are some major attractions to the proposal discussed above. It could provide a vehicle for substantially increasing market discipline without the potential disruption and uncertainty of expanded payoffs. In many instances recapitalization and voluntary merger will occur in place of failure. This proposal is likely to work better and have more credibility than a payoff where the largest banks are concerned. Implementing of capital standards would not preclude using more payoffs according to the modified formats discussed above.

Th FDIC is not prepared to endorse this concept at this time. A number of details would have to be worked out before it could be implemented, but it appears to warrant consideration in addition to, or in lieu of, the risk-sharing proposals considered above.

DEPOSITOR PREFERENCE

At the present time, depositors are considered general creditors in bank liquidations except in a few states in which their claims specifically on the assets of a failed state-chartered bank are preferred over those of other general creditors. Significant benefits would derive from the standpoint of increasing market discipline from granting depositors and certain other creditors preference since the potential loss exposure of selected creditors would be increased. In addition, it would facilitate the use of the payoff/cash-advance option in handling bank failures.

There are several categories of nondeposit general creditors that may be present when a bank fails. These include nonsubordinated lenders. If a depositor preference were legislated such lenders might choose to become depositors. While that would not materially affect a bank's balance sheet, the deposit assessment base would be increased, as would be appropriate.

General claimants on a bank might include unpaid employees, claims arising from mechanics' liens, claims arising from torts, etc. Because of the special nature of these claims and the fact that the claimants have no reason to be concerned about a bank's condition, there would be no reason to prefer depositors over these claimants.

However, those claims which are generally categorized as "contingent" should be subordinated to depositors. These might arise, for instance, in connection with standby letters of credit and nonperformance by the failing bank with respect to commitments or loan participations. These would be related to commercial transactions with financial institutions and other businesses. If depositors were preferred to these claimants, the latter would have to be more concerned about whom it does business with, provides guarantees, etc. The FDIC believes that such increased concern would be appropriate and would act as a check on bank risk in some areas.

In the payoff/cash-advance transaction, a depositor preference over the latter category of contingent claims would enable the FDIC to make a more substantial cash advance in some cases. (In some instances depositor recoveries are significantly reduced because of questionable guarantee arrangements which were unknown to the depositor or beyond his or her comprehension.) It would also favorably affect ultimate depositor recovery and FDIC recovery at the expense of the contingent claimant.

It would be necessary to spell out carefully through legislation who would be preferred. On balance, the FDIC believes this would improve the fairness of the system and increase market discipline.

ADDENDUM

Administrative and Operational Considerations

Coupled with any change (or in the absence of any change) in the FDIC's method of resolving a failing bank situation, the administrative and operational obstacles associated with a relatively large bank closing must be addressed. While implementation of any of the previously enumerated approaches would add some additional operational burden, the FDIC's system is flexible enough to adapt to such a change. However, the underlying mechanics of effecting a rapid settlement of claims when a relatively large institution is involved impede the goal of providing the banking public with timely availability of usable funds. Such considerations have been and continue to be a major constraining factor.

Simply stated, the FDIC is not capable of handling the payoff of a very large banking organization under present procedures if "next business day" access to funds by depositors is to be accomplished. The tradeoff between increased cost to the insurance fund and potential disruption caused by delay in settlement may be a major obstacle to the effective use of these loss-sharing approaches on a consistent basis.

A number of time saving procedures and improved methods of dealing with the operational problems involved with the closing of a large banking institution are currently being explored. Chief among these considerations is an increased emphasis upon planning and coordination of the liquidation effort before a bank closing. Specific recommendations, some of which may require enabling legislation, follow:

1. Recordkeeping and Reporting

Analysis of an institution's deposit structure and the accurate assessment of the FDIC's insured-deposit liability is essential in preparing for any bank closing and subsequent payoff. For example, the current practice of aggregating individual depositor balances in a closed bank (to distinguish between insured and uninsured funds) is a time-consuming and highly labor-intensive task. The increased use of automated equipment and specialty computer software packages in this area has a great potential for time savings.

To be effective, however, certain modest changes in bank recordkeeping and reporting requirements may be necessary. For insured institutions with deposits greater than $1 billion and for those rated 3, 4 or 5 under the Uniform Interagency Bank Rating System, records could be maintained which would provide for a "central locator file" (or equivalent) and reports on the institution's insured deposit liability could be submitted periodically to the FDIC. By limiting these requirements to only a small number of relatively large institutions (most of which already maintain some form of a central index file for their own internal use) and to poorly-managed institutions, the increased reporting and bookkeeping burden would be held to a minimum and would be borne only by those few institutions which pose the greatest level of potential exposure to the deposit insurance fund.

2. Modify Insurance Coverage

Over time, a cumbersome and rather complex system for determining individual insurance coverage has evolved. Increased coverage can be achieved by the utilization of individual accounts held in different rights and capacities, to obtain insurance protection for deposits which aggregate to substantially more than $100,000. A simplification of these rules, which serve to encourage "account splitting," to provide for only a maximum $100,000 coverage for each individual or business entity, per bank, would have several favorable effects.

First, because it would represent a roll back of insurance protection for a few individuals with large deposit balances, it would serve to increase market discipline as account splitting would be less advantageous. Second, it would be more easily understood by both bankers and the general public and could reduce the volume of litigation involved. More importantly, however, it has the potential to significantly decrease the time involved in processing of accounts in a bank closing situation. Calculation of insured coverage would be greatly simplified and could be more rapidly processed by automated equipment programmed to [illegible] by bank customer number. This would greatly facilitate the settlement procedure, and the time savings would be substantial in a relatively large [illegible]

3. Passthrough of Existing Contractural Arrangements

Certificates of deposit and other "time" deposit accounts are contractural arrangements whereby the depositor is not generally able to demand funds until a stated date or the passage of a known and certain period of time. The "event" of a bank closing may negate these contracts, effectively rendering them payable upon demand. If the stated contractural terms of these accounts could be clearly permitted to "pass through" to another operating institution in any subsequent deposit assumption transaction, their value would generally increase. This would facilitate the transfer of large blocks of funds, permitting a more rapid settlement of other claims.

4. Subordinated Claims and Financial Assistance

The FDIC has been and remains reluctant to utilize the deposit insurance fund to neutralize normal free-market forces by assisting in the preservation of those institutions which have proven to be unable to compete effectively on their own. Direct financial assistance to an open bank, under Section 13(c) of the Federal Deposit Insurance Act, aimed at avoiding the disruptive consequences of a failure, accrues to the benefit of subordinated creditors and shareholders who should be expected to sustain a loss as a consequence of poor management practices. The increased prevalence of subordinated debt in a bank's liability structure (as discussed in this chapter) can render unfeasible an open-bank merger involving a troubled institution because these creditors cannot be compelled to incur a loss unless the bank is closed.

Assistance might still be granted and serious disruption avoided in a manner which will not benefit stockholders and subordinate creditors in an insolvent institution. This can be accomplished by effecting a phantom merger transaction with a newly-chartered bank which has been capitalized by the granting of FDIC financial assistance. The new institution would assume the liabilities of the closed bank and purchase its high-quality assets. As the estimated value of an insolvent bank's assets will not exceed the liabilities assumed, shareholder claims will have been effectively eliminated.

The new institution could be operated by the FDIC (utilizing the closed bank's records, facilities and appropriate personnel) until such time as its affairs can be terminated in an orderly fashion or sold to and recapitalized by a new group of investors. Use of this interim vehicle would be intended to only delay the normal free-market resolution of an insolvent firm; it would avoid disruption to funds flows and bank customers while penalizing those investors who have chosen to bear a risk of loss.

5. FDIC as Receiver for all Insured Institutions

Section 11(c) of the Federal Deposit Insurance Act provides that the FDIC shall be appointed receiver for any National bank closed by the Comptroller of the Currency. This authority should be expanded to include all FDIC-insured state-chartered institutions.

In practice this would not represent a significant change as the FDIC is nearly always appointed receiver when an insured state bank is closed. Occasionally, however, the decision to appoint the FDIC is delayed until immediately prior to closing and may involve factors other than who may be better able to protect the interests of creditors.

It is important for the FDIC to know sufficiently in advance of a bank closing that it will be appointed Receiver in order to plan for the orderly liquidation of assets and processing of claims. Planning takes on even greater importance to carry out concepts such as modified coinsurance where the increased procedural difficulties must be resolved quickly. Since the FDIC usually has, by far, the largest claim in closed bank liquidations, it is only appropriate that the FDIC be appointed the receiver for all insured banks.

6. Brokers

The emergence of brokers who perform a deposit-parceling function for the purpose of maximizing deposit insurance coverage undermines efforts to establish discipline in the banking system through risk-sharing by large depositors. The FDIC believes the activities of such brokers must be controlled as an integral part of any risk-sharing proposal and is considering a number of alternatives for correcting this problem. The FDIC is particularly concerned about the practice of some brokers of placing fully-insured funds in banks at random without credit analysis or, worse yet, placing them in known problem banks and collecting a higher fee.

CHAPTER IV

PUBLIC DISCLOSURE PRACTICES

Page

Executive Summary IV-1

Introduction IV-2

Functions of Disclosure IV-2
  Enhance Market Discipline IV-2
  Protect Bank Depositors and Other Customers IV-3

Other Considerations Bearing on Disclosure IV-4
  Reporting Burden on Banks IV-4
  Public Nonuse of Data IV-5
  Potential Public Overreaction to Disclosures IV-7

Adequacy of Disclosures IV-7
  Information Currently Available to the Public IV-7
  Available Information and User Needs IV-10
  Data Withheld From the Public But Available to Regulators. IV-11
  Reports of Examination IV-11
  Administrative Actions IV-11
  Country Lending Survey IV-12

FDIC Position on Public Disclosure IV-13
  Educate the Public IV-13
  Make More Information Available to the Public IV-14
  Evaluate Agency and Public Data Needs IV-16

CHAPTER IV

PUBLIC DISCLOSURE PRACTICES

EXECUTIVE SUMMARY

Improved disclosure of bank financial and operating information will help focus stronger market discipline on risk taking by banks. Such discipline can serve as an important supplement to federal regulation and supervision of institutions.

The chapter concludes that more and better information should be made available to the public. To facilitate this process, FDIC has developed two proposed policy statements and is presently in the midst of instituting major revisions to the Reports of Condition and Income ("Call Reports") to obtain more comprehensive data for risk analysis. One of the proposed policy statements encourages banks to disclose, and uninsured depositors to request, relevant information relating to bank condition and performance. The proposal sets forth a minimum standard for bank disclosure. A key element of this disclosure is management's narrative analysis of the bank's results of operations and financial position. The FDIC is also considering a policy of publishing in the Federal Register final statutory enforcement actions taken against banks. Additions to the Call Reports will provide the regulators and the public with data on credit and interest-rate risks, areas not previously covered in these reports. An issue of competitive equity remains, however, as savings and loan associations do not disclose data on loan quality.

Bankers should not look with fear at the FDIC's emphasis on disclosure. Better disclosure will protect sound, well-run institutions by distinguishing them from the minority in the industry that have been willing to take excessive risks. Informed depositors will be better able to identify and avoid these marginal banks, which will promote more stability in customer relationships at the better banks.

The public currently has an extensive amount of bank financial data available from various sources, including Call Reports and, from certain banks, disclosures mandated by Federal securities laws. Banking organizations devote considerable time and expense to preparing reports to which the public has access. This chapter discusses the adequacy of existing disclosures, the ability and willingness of the public to understand available information, and the need for improved disclosure. The chapter makes the point that the information should be pitched to the level of a reasonably sophisticated depositor investing amounts that exceed the statutory insurance limit. It is these and larger institutional depositors who may be expected to provide market discipline on banks.

Bank customers whose funds are fully protected by deposit insurance cannot be expected to assess bank risk. In a survey of large depositors, the FDIC found that many lack the skill to perform such an assessment. Other large depositors who have the resources to analyze the available bank data have little incentive to do so because they perceive no risk in dealing with large banks. They believe that the FDIC will handle the failure of a large bank in the way that will protect all depositors, insured or not. This large depositor attitude is an important competitive and disciplinary factor that must be acknowledged and addressed. The ideal solution is to expose large creditors to loss in fact, not just in theory. Clear and meaningful disclosure to bank customers who are at risk, in turn, is an essential corollary to the exposure to increased risk.

Financial advisors and sophisticated bank customers generally regard the information presently available to them as adequate for analysis of the country's largest banking organizations, but for small institutions the financial data is less complete. Even for the analysis of risk in large banks, these data users would benefit from more data on loan quality. The examination process and other supervisory activities provide the regulatory agencies with information on bank condition and performance, including loan quality, which is withheld from the public. The chapter reviews this situation and certain issues relating to public availability of such data.

INTRODUCTION

Disclosure is the process by which information concerning a bank's financial condition and performance, its management, and its policies and philosophies is made known to the public at large. Disclosure can occur at the institutional level or through the release of information by the regulatory agencies. Regardless of the source for disclosure of data, its availability may be the result of specific legal or regulatory requirements or of voluntary action on a bank's part.

FUNCTIONS OF DISCLOSURE

Enhance Market Discipline

The market's ability to make informed investment decisions requires full and fair disclosure of relevant information. Market participants can then assess the degree of risk associated with an investment in, or other relationship with, a bank. Based on an evaluation of the condition of an institution, market participants may demand an appropriate risk premium to boost the return on investment to a level which is commensurate with the perceived risk. If the market's general consensus regarding the condition of a particular bank causes it to seek an inordinately large risk premium or to withdraw from existing business relationships with the institution, the bank's cost of doing business will increase and its ability to continue as an operating enterprise may be reduced. To ensure that it remains viable, the bank's expected response to such a situation would be to strive to restore its financial condition to a more acceptable level and to temper those managerial policies responsible for its increased risk.

Market participants who are at risk in their relationships with a bank will exercise some discipline on the bank's behavior toward risk. This discipline would be intended to restrain the bank from taking excessive risks and engaging in destructive competition. The success of market discipline as a means to keep banks operating in a safe and sound manner is directly proportional to the value of the information available to market participants.

Under the concept of large depositor risk-sharing, the disclosure of relevant information takes on added importance. If a risk-sharing scheme is adopted by the FDIC, one can no longer assume that there is no risk to uninsured depositors in a "large" bank because of a perception that the FDIC would not pay off such a bank. Large depositors will therefore need adequate and timely financial disclosures in order to assess their risk exposure. Banks that possess a low risk of failure will be deemed acceptable depositories by large depositors or their financial advisors. As a bank moves toward a position of perceived excessive risk, an increasing number of large depositors will remove its name from their lists of acceptable banks. It is the bank's understanding of this cause-and-effect relationship that will serve as a deterrent to risky banking practices.

Protect Bank Depositors and Other Customers

In the deregulated environment in which banks are now operating, uninsured depositors as well as other creditors and customers need to protect their interests more than they have in the past. In previous years, most bank failures could be attributed to either fraud or excessive loan losses. While banks will continue to be exposed to these types of losses, the potential for loss resulting from interest rate risk has gained increasing prominence due to the volatility of market rates and the increasing volume of deposits free of Federally-imposed interest rate ceilings. In addition, some banks are exhibiting a greater willingness to make more risky investments which, while generating higher returns, are more likely to experience repayment problems.

Banking is also becoming more competitive both within the industry itself and with other providers of financial services. Individual institutions must work harder to retain depositors and borrowers due to increasing competition from banks in the local, regional, national or international markets. Thrift institution powers have been expanded so that savings banks and savings and loan associations are beginning to closely resemble commercial banks. Securities firms offer alternatives to bank deposits and the banking industry has responded by providing a limited securities-brokerage function.

Hence, many factors have contributed to the increased risk of failure within the banking industry. The post-World War II record number of failures in 1982 (42) presages the higher volume of bank closings that can be expected in an era of deregulation. As deregulation progresses, the conditions giving rise to a payoff may occur with somewhat greater frequency, and the perception that the government will normally protect all general creditors may fade. It will no longer be sufficient for uninsured creditors to ignore risk and look only for the highest return that is offered by a spectrum of financial institutions.

OTHER CONSIDERATIONS BEARING ON DISCLOSURE

Reporting Burden on Banks

Banks incur significant costs in collecting, preparing and transmitting information which they are currently required to report to regulatory agencies, their stockholders, and the public at large. This reporting burden varies from bank to bank depending on such factors as total assets, type of charter, number of stockholders, holding company affiliation, and relationship with independent public accountants. These factors determine the type and frequency of reports designed for external users.

The incremental cost to banks of preparing reports for external users increases as the reported information loses utility to the bank. For example, there is very little incremental cost of external reporting if what is reported is identical to data already used internally by bank management. Reporting costs increase, however, when internally used data must be adjusted to present it in conformity with specific reporting requirements. Finally, the cost is greatest when the bank must collect and prepare data which is of no practical utility to management itself.

The Reports of Condition and Income are the primary reporting vehicles for bank disclosure to the Federal bank regulatory authorities. Because these reports are used for a variety of purposes and by many different users, portions of the data required to be reported are not precisely the same as data used internally by bank management and, in some instances, are of little or no use to bank management. Hence, the banks' preparation burden and costs for these reports are significant.

As an insurer, the FDIC seeks to limit its financial exposure by monitoring the condition and performance of banks. Call Reports are important in this regard; their content provides uniform input for computerized surveillance systems designed to identify banks warranting special attention. Hence, the banks' preparation costs for a significant portion of these reports can be regarded as an indirect cost of FDIC insurance.

For many banks, particularly small institutions, the financial information contained in the Call Reports, which is publicly available, represents the only financial statement to which depositors and other customers may have access. Since banks are obligated to submit the Reports of Condition and Income to the regulatory agencies for supervisory purposes, banks experience no additional reporting burden when the agencies disclose this data to the public upon request. Nevertheless, there are certain other Federally-mandated reporting requirements applicable to banks for which the regulatory agencies themselves are not the intended beneficiaries.

In particular, some banks are required to file reports under the Federal securities laws with their Federal bank regulatory agency whose responsibility is to act as a repository for this information and to assure the public's accessibility to the data. A degree of similarity exists between the prescribed content of Call Reports and the periodic financial reports required under the securities laws. In fact, the securities disclosure rules governing the form and content of bank financial statements reference the Call Report instructions. The practical effect of this cross-referencing is to limit the cost of reporting to these banks by allowing them to utilize figures developed for Call Reports in financial reports required by securities laws.

Nevertheless, the Federal securities laws impose additional reporting burdens and costs on banks subject to the regulations promulgated thereunder. Only about 680 of the approximately 14,400 insured commercial banks currently fall within the reporting requirements of Federal securities laws. However, a steadily growing number of commercial banks, now approaching 18 percent of the total population, are indirectly falling within the jurisdiction of the Securities and Exchange Commission ("SEC") through their parent holding companies. These banks therefore indirectly incur a portion of their parents' cost and burden of complying with the SEC's registration, disclosure, and periodic reporting requirements.

There are potential diseconomies involved in expanding disclosure beyond what is currently made available. The existing compliance costs to the banking system inherent in assembling data for external scrutiny is significant. Potential informational demands on banks may encounter diminishing returns at some future date. The utility of these external demands must be measured by cost/benefit analysis.

Public Nonuse of Data

Integral to the disclosure issue is an analysis of the willingness and ability of the public to comprehend bank financial data. It is important to realize that the public is not homogeneous but consists of several distinct sectors of which only a few may be at risk in their relationships with banks. The largest sector can be designated "the general public" and would be composed of most individuals, small businesses, and other small local entities that are unsophisticated users of financial information. The remainder of the public consists of such groups as bankers, corporate treasurers, institutional investors, fund managers, municipal treasurers, and other large depositors as well as rating firms and other financial advisors which are typically, although often erroneously, described as sophisticated.

A theory has been advanced stating that the public does not make use of presently available bank financial information because they are unaware it exists. This argument is persuasive with respect to the general public. However, for the most part, the general public is exposed to little if any risk in its dealings with banks. In contrast, two surveys conducted by the FDIC reveal that a portion of the public, very small perhaps in terms of number but large in terms of the funds it controls, is very aware of currently disclosed data. Nevertheless, the FDIC found that certain supposedly sophisticated large depositors are in fact no more knowledgeable than the general public.

Even in those cases where the public is cognizant of the bank financial information available to it, the information will not be utilized if the public does not know how to analyze it. Our surveys indicate that the general public and the treasurers of many smaller corporations and governmental units have little understanding of basic bank financial information. Apparently, it is only the truly sophisticated data users, including institutional investors, investment banking firms, rating firms, large money funds, large banks, and large corporations, that possess the proper analytical skills for evaluating risk in banks.

While advanced techniques of financial analysis are largely unknown to all but these most sophisticated of bank customers, there has been an increasing recognition during the past few years among corporate treasurers and other customers with extensive banking relationships of the importance of assessing bank performance and the need for understandable information concerning the condition of banks. In lieu of developing the internal resources to perform bank analysis themselves, many customers of this type have opted to rely on credit ratings of individual banks prepared by firms which specialize in bank analysis. However, other less-sophisticated uninsured depositors continue to lack both an awareness of bank data availability and the ability to use and understand the data. This situation can be alleviated by educating these customers and by making disclosures less technical, yet more comprehensive and informative.

A final factor purporting to explain the public's disinterest in bank financial data relates to the general perception of risk and the role of deposit insurance. As addressed in Chapter III of this study, the perception of risk does not appear great, especially in the larger banks. The degree to which the recommendations concerning risk-sharing are adopted will affect both the demand for information and the motivation to analyze and understand it.

To the extent that the market will seek out bank financial information in the form that is most understandable, the most efficient and cost-effective mechanism for accomplishing this objective may be through the continued growth of professional services provided by private sector bank rating firms. These firms can apply their expertise in analysis and translate bank financial data into a form which is clear and understandable to the average well-informed user.

Rating firms analyze the condition of selected banks, including virtually all the largest commercial banks, at their clients' request. While expanded utilization of rating services may ultimately provide enhanced public understanding of the condition of large banks, it does not address the issue with respect to smaller (under $500 million) institutions. This is particularly troublesome in view of the small bank uninsured depositors' risk that a failure will lead to a payoff rather than a purchase and assumption, given the FDIC's present choices for handling a closed bank.

Potential Public Overreaction to Disclosures

Bankers often express concerns that public misinterpretation of information regarding bank condition will cause overreaction and runs on banks. News of initial depositor withdrawals as a result of problems, real or imagined, at a bank would feed on itself and lead other depositors to lose confidence. The snowball effect of this could result in the bank's failure. However, the FDIC is not aware of any instance in modern times where a sound bank has faced liquidity pressures due to unfounded depositor concerns.

If more creditors are placed at risk due to some form of risk-sharing arrangement, that fact alone will add some volatility to banking. Given, then, that some degree of public lethargy will give way to awareness and interest, the best protection against spontaneous loss of confidence is twofold: (1) greater care by bankers to avoid unnecessary asset concentrations, lax lending, excessive leverage, and other conditions which could act against the welfare of the bank; and (2) a systematic, dependable disclosure of information, which will eliminate the data vacuum which is too often filled by rumor or ill-considered and poorly-presented half-truths. There are few, if any, institutions which so profoundly affect the public interest, but are so universally misunderstood, as banks. In the FDIC's view, the public has a need and right to make its own judgments with respect to banks. Moreover, it is in the long-run best interests of banking to combat the existing mystique and misunderstandings.

ADEQUACY OF DISCLOSURES

An important function of the FDIC, especially in an era of deregulation, is to promote public confidence in banks and in the system as a whole. Implicit in the role of maintaining public confidence is ensuring that adequate information relating to bank condition is disclosed to the public.

Moreover, as deregulation of banking and other financial services proceeds, the overall level of risk to which bank customers' funds are exposed can be expected to increase. The concept of adequacy from a public policy standpoint is relative, i.e., it is a function of the volume of funds at risk within a bank. Hence, as the percentage and absolute dollar amount of uninsured deposits in and other general creditor claims against a bank increase, so does the need for information to assess the amount of risk in the bank. The present reporting rules for financial institutions have been designed so that the quantity of publicly-available data is generally more extensive for larger banking organizations than for smaller ones. The practical effect of this is positive, since the greatest volume of uninsured deposits and other liabilities are found in the largest banks.

Information Currently Available to the Public

All commercial and mutual savings banks insured by the FDIC are required to file Reports of Condition and Reports of Income with their primary supervisory authority at a prescribed frequency. Commercial banks file these reports on a quarterly basis whereas mutual savings banks file quarterly Reports of Condition and semiannual Reports of Income. These Call Reports consist of a balance sheet, income statement and supporting schedules on preprinted forms provided to each institution by the Federal agencies.

While the general content of the Call Reports is similar for all commercial banks, differences do exist in the level of reported detail based on a bank's size and the nature of its business. A single set of report forms is applicable to all of the approximately 300 mutual savings banks insured by the FDIC. Call Reports present numerical data relating to bank condition and performance without any provision for the inclusion of narrative explanations to discuss the underlying factors influencing the reported results. The financial information contained in these reports is not required to be audited although their correctness is attested to by bank directors and/or an authorized officer of the bank. The Federal banking agencies have made the Call Report data for individual banks publicly available for ten years.

These Reports of Condition and Income have traditionally been used for the collection of general statistical and research-oriented information and their content reflected such usage. More recently, the Call Reports have assumed greater importance in the supervisory process and are the principal data source for automated surveillance systems such as the FDIC's Integrated Monitoring System. Efforts to improve the value of the Call Reports for monitoring the safety and soundness of individual banks between examinations are discussed later in this chapter.

Since December 1981, the Uniform Bank Performance Report ("UBPR"), a separate document which brings together a wealth of financial ratios derived from the most recent and four preceding Call Reports, has also been made available to the public on an individual bank basis. For each ratio presented, the UBPR also contains the median ratio as of the most recent Call date for a reference group of the bank's peers together with the percentile level at which the bank's ratio falls within the peer group. This comparative data adds to the UBPR's value because it shows the relative standing of a bank to a user who may not fully grasp the meaning of all of the ratios in the report.

Titles VIII and IX of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 ("FIRA") prescribe an annual reporting requirement for all insured banks with respect to loans to insiders. Each bank must submit to its primary Federal bank regulator specified information on the indebtedness of principal shareholders and executive officers who were indebted to the bank or its correspondent banks in the past calendar year. Both the reporting bank and its bank regulator are required to make the report available to the public on request.

The next level of disclosure affects banks with publicly-held securities rather than all insured banks. In 1964, amendments to the Securities Exchange Act of 1934 ("1934 Act") extended its coverage to banks with more than $1 million in total assets and a class of equity securities held by more than 500 stockholders or with a class of securities listed on an exchange. Section 12(i) of the 1934 Act assigns the related enforcement authority over banks to the three Federal bank regulatory agencies. Each agency has issued comparable regulations setting forth the registration, disclosure, and periodic reporting requirements for bank issuers of such securities. These disclosures are designed essentially for the use of investors in bank stock and subordinated notes and debentures but are also relevant to others, such as uninsured depositors. Less than five percent of the 14,400 insured commercial banks are "registered" under the 1934 Act.

Bank holding companies are subject to certain regulatory reporting and securities disclosure requirements that parallel those for banks. Companies reporting under the Bank Holding Company Act of 1956 submit financial reports to the Federal Reserve System ("FRS"). This information is generally available to the public. The Annual Report of Domestic Bank Holding Companies (Form Y-6) contains comparative consolidated (with certain exceptions) and parent only financial statements as well as comparative statements for each nonbank subsidiary. However, the Y-6 lacks such data for bank subsidiaries of the parent holding company. The holding company must also report certain specified data on its organizational structure in the Y-6. Additionally, holding companies with total consolidated assets of $50 million or more file the Bank Holding Company Financial Supplement (Form Y-9). As with the Call Reports, the Y-9 consists of preprinted forms for the balance sheet and income statement. The forms must be prepared annually or semiannually depending on the size of the holding company.

The SEC administers the reporting and disclosure requirements of the 1933 and 1934 Acts with respect to bank holding companies. Holding companies must register any public sale (excluding certain small sales) of debt or equity securities with the SEC and provide a prospectus with content similar to that of an offering circular to each prospective purchaser. Publicly-held holding company securities must be registered with the SEC in accordance with the same criteria that applies to registered bank securities. Subsequent to registration, the holding company must provide its stockholders with proxy statements and annual reports (including financial statements) and must file quarterly financial information and other disclosures with the SEC on a prescribed basis. All of this information is available to the public.

Full and fair disclosure under the Federal securities laws requires disclosure of any outstanding cease-and-desist order along with a description of the underlying conditions within the bank which gave rise to the order. This applies not only to bank disclosure materials but also to filings by SEC-registered bank holding companies. Should the extent of supervisory action against a bank be limited to an informal agreement such as a Memorandum of Understanding, the policies of the FDIC limit the required disclosure to a discussion of the material factors underlying the provisions of the memorandum. Voluntary disclosure of the existence of a memorandum is not discouraged.

The FDIC began to publish summaries of its statutory enforcement actions approximately six years ago. Effective January 1, 1980, the Federal Financial

Institutions Examination Council ("FFIEC") extended this policy to actions taken by all five member agencies. While the name of the bank involved and other identifying details are deleted from each summary, a large depositor or other person who closely follows a particular institution could fairly readily connect it to a specific summary and then request a copy of the actual order via the Freedom of Information Act ("FOIA"). Since final orders are available through FOIA requests, albeit in a "sanitized" condition, the FOIA can also be considered a disclosure vehicle. A response that no order is outstanding against a specific bank could represent a form of limited assurance regarding the condition of that bank.

More complete descriptions of existing public disclosures appear in Appendix C.

Available Information and User Needs

In order to gain an awareness of procedures used to monitor bank condition and to determine whether the financial and other bank data presently available satisfies the needs of its users, the Division of Bank Supervision staff conducted two surveys. The first was a telephone survey of 55 persons, including treasurers of major U.S. corporations, institutional investors, municipal treasurers, and uninsured depositors in banks receiving FDIC financial assistance. The second involved meetings with representatives from three firms prominent in the field of bank analysis and ratings.

According to the surveys, the amount of publicly-available data on banks exceeds that which bank customers other than sophisticated users can comprehend. Sophisticated users would like to receive more data in specific areas. More and better data on loan quality, particularly on foreign loans, is considered very desirable. In addition, these groups stated that a universally-accepted and consistently-applied definition of the term "nonaccrual loan" needs to be developed to improve comparability. Sophisticated users who wish to keep their assessments of bank condition current must also struggle with the length of time between the end of a reporting period and the date when the financial information for this period is publicly released. To overcome these difficulties, many corporate treasurers, fund managers and rating firms take advantage of their status as holders of, or advisors to holders of, large amounts of bank deposits and contact management directly when they need to gain answers to unresolved questions relating to bank condition.

Finally, the financial data that users regard as adequate today may not satisfy their informational requirements for a proper analysis of bank risk in the future. Disclosure is an evolutionary process, changing in response to the financial markets' demands for data. As banks gain more freedom to enter into new activities and as the impact of deregulation continues, the content of bank disclosures may need to be very different than it is at present.

Data Withheld From the Public But Available to Regulators

As part of their supervisory and enforcement activities, the bank regulatory agencies assemble but withhold from the public a considerable amount of information bearing on bank condition and performance. Such data may be compiled through the examination process or related bank contact or may be reported directly by banks.

Reports of Examination

Through the authority to conduct examinations of banks, the three bank regulatory agencies have a powerful tool for assessing an individual institution's exposure to risk. Examiners employ procedures and methods designed to permit them to evaluate the bank's capital adequacy, asset quality, management, liquidity position, and earnings capacity. Examiners present findings with respect to the bank's overall condition in the form of summary comments and conclusions that inform the reader of the bank's problems and serve as a guide for needed corrective action. Public access to reports of examination, in whole or to selected parts, would therefore provide a clear indication of the problems and weaknesses which the bank's primary Federal regulator views as significant.

The bank regulatory agencies have always maintained the confidentiality of reports of examination and resisted attempts to gain disclosure of their contents. The basis for the agencies' position is that the examiner's comments and conclusions, adverse classifications of loans and other assets, and other reported information reflect subjective judgments made by their examination staffs rather than formal determinations made by the agency acting through its board of directors.

Examiners form their judgments through discussions with a bank's officers and its board of directors and a review of bank records and documentation. The public disclosure of subjective judgments of examiners would be an inconsistent type of disclosure which would be subject to perhaps widely ranging interpretation depending upon the sophistication of the reader. Moreover, as the length of time between examinations increases, comments and data from the latest report of examination may tend to lose their relevance and may no longer accurately portray the bank's condition.

Administrative Actions

Congress has given the bank regulatory agencies broad enforcement powers to complement their examination function. Through these means the agencies seek to fulfill their mission of promoting strength and stability in the banking system. Examination findings reveal the extent to which varying degrees of corrective measures are needed at an institution. For a bank regarded as having no more than modest weaknesses that are correctable in the normal course of business, the supervisory response is limited. However, once a bank exhibits a combination of weaknesses that are moderately-severe or worse, the regulatory agencies presume that administrative action, formal or informal (depending on the seriousness of the situation), is necessary to assure that the desired corrections are achieved.

Informal administrative actions generally take the form of Memorandums of Understanding which address specific matters in need of correction within an institution. These documents are usually drafted at the regional level and jointly signed by an appropriate regional official and by the bank's board of directors. The three banking agencies may also initiate formal administrative actions by exercising their statutory enforcement powers. Such actions include cease-and-desist orders as well as suspension and removal orders. The FDIC Board of Directors also has the power to terminate insurance. In addition, the bank regulatory agencies possess the authority to assess civil money penalties for violations of certain statutes.

Routine disclosure of both formal and informal agreements is not made as a matter of policy by the regulatory agencies. On the other hand, as discussed above, the FOIA provides a vehicle for indirect disclosure of formal agency actions. Such a procedure is not an efficient method for ensuring that all market participants are aware that a final order has been issued against a bank. This inefficiency can be eliminated through greater public access to final orders issued at the conclusion of formal actions.

The effect of increased disclosure of such final orders would be to subject banks against which these actions have been taken to potentially greater public scrutiny. Institutions which have been poorly-managed would be less able to hide their condition under a veil of secrecy. Greater disclosure would aid large depositors and other bank customers in their evaluation of bank performance by giving a clear indication of those institutions whose managements have been unable or unwilling to prudently direct the affairs of their banks. In a deregulated environment, therefore, public knowledge of those banks against which final orders have been issued will protect well run banks by distinguishing them from their more marginal competitors. Such information will reassure depositors and other bank customers and promote the stability of their relationships with sound institutions.

Since the vast majority of insured banks do not actively participate in the market for uninsured funds, these banks could claim that the absence of uninsured depositors and other nondeposit creditors eliminates their customers' need to be aware of enforcement actions. Even so, it is doubted that the public would be indifferent to the presence of an administrative action against the local bank. To the extent that is true, the discipline the FDIC seeks to achieve would result.

Country Lending Survey

The banking agencies presently collect information semiannually on cross-border lending by selected U.S. banks. Approximately 160 banking organizations submit these data which are then aggregated by country, including profiles on type of borrower and maturity. These aggregated data are made available to the public upon request. Additionally, publicly-available data include separate totals for three size groups: the nine largest banks, the next 15 largest, and all other reporters. Information on the gross capital funds of these groups is also provided so that a user may calculate the exposures relative to capital funds for each of the groups.

The bank regulatory agencies are presently studying proposals to increase both the reporting frequency (to quarterly) and the amount of information which would be made publicly available. This latter proposal would have each reporting bank identify those countries in which it had large exposures, *e.g.*, those in excess of one percent of total assets, for release to the public upon request.

There are problems associated with the disclosure of foreign lending, including the fact that its relevance and potential impact are dependent upon developments beyond our own borders and are, therefore, difficult to assess properly. Nevertheless, the extent of bank exposures to the transfer risk and the exchange rate risk associated with this type of lending suggests that country-lending data are relevant to the analysis of the overall financial condition of a bank. The SEC reached that same conclusion late in 1982 when it issued Staff Accounting Bulletin No. 49 concerning disclosure of cross-border lending to countries that are experiencing liquidity problems.

FDIC POSITION ON PUBLIC DISCLOSURE

The FDIC's conclusions regarding the public disclosure of information lead in three directions. These measures do not represent a one-time resolution of the issue. Rather, they illustrate the framework for an appraisal process that continuously recognizes that information deemed relevant to the public's analysis of risk changes in a dynamic and evolving banking system.

Educate the Public

The present system of limited deposit insurance places many depositors' funds at risk. By adopting a large depositor risk-sharing approach to insurance, the public perception that all or most uninsured deposits are riskless should dissipate and be replaced by an awareness of the need to evaluate bank risk. An evaluation of a bank's condition can succeed only where disclosures are informative to the user and go beyond bare numerical data that are devoid of explanatory comments.

The Federal Deposit Insurance Act and other statutes do not appear to contain legal authority for the Federal bank regulatory agencies to impose a blanket requirement that all banks provide a minimum level of disclosure to uninsured depositors. Such disclosures would permit uninsured depositors to make informed financial decisions with respect to the placement of their funds.

Some observers might argue that the FDIC should explicitly seek such authority in conjunction with the adoption of any plan to increase risk-sharing by large depositors. The responsibility for providing relevant disclosures to the public properly rests with those institutions that are seeking to maintain or enlarge their share of the market and not with the Federal bank regulatory agencies. For this reason, and in the absence of clear authority to issue a regulation in this area, the staff has proposed that the FDIC adopt a Statement of Policy that would encourage the voluntary provision of financial data by banks to their depositors and other interested customers.

The proposal also suggests a minimum standard of bank disclosure that is basically designed to help educate the public by identifying the types of information that the FDIC believes are relevant to an assessment of bank risk. At the same time, to minimize the burden on banks, the policy statement attempts to limit the amount of information recommended for disclosure that is not already maintained by banks.

A key element of this disclosure is management's narrative analysis of the bank's results of operations and financial position. The policy statement sets forth general guidelines for subjects that may warrant inclusion in this narrative, but provides management with considerable flexibility in determining the scope of the discussion. This offers management the opportunity to comment upon the raw numbers in its Call Reports which, if analyzed without the benefit of such a discussion, might lead the user to an inappropriate interpretation of the bank's condition. As such, management's narrative might be viewed as an educational device that would help to introduce the less-sophisticated reader to the mechanics of financial analysis.

Make More Information Available to the Public

The financial information contained in bank Reports of Condition and Income has been publicly available for ten years. Supervisory usage of this Call Report data has greatly increased during the past several years as offsite computer based surveillance systems have become more sophisticated. To date, however, the Reports of Condition and Income have essentially corresponded to a balance sheet, income statement, and supporting schedules which, as noted earlier, fail to provide sufficient information for a complete analysis of bank risk. In order to enhance the usefulness of the Call Reports as a supervisory and surveillance tool, the Task Forces on Supervision and on Reports of the FFIEC undertook an evaluation of these reports, and in June of 1982 proposed substantial revisions to the Reports of Condition and Income. In addition to reformatting most of the existing report schedules, the FFIEC proposal recommended the addition of certain new schedules and other selected data items, which will supply the regulatory agencies with information needed to strengthen the supervision/surveillance process.

The new key elements of the Call Report package are a separate, self-contained report on past due, nonaccrual, and renegotiated loans and leases and schedules for reporting on interest rate sensitivity and on certain commitments and contingencies. The past due loan report was implemented as of December 31, 1982. Initial collection of the new Report of Condition schedules is planned for June 30, 1983. Additionally, quarterly submission of Reports of Income by all banks regardless of size commenced on March 31, 1983. The reporting burden imposed on banks by these new requirements, the interest rate sensitivity schedule in particular, is a concern because they represent a significant increase in paperwork burden.

The public availability of the existing Call Report documents has not been a subject of significant objection in recent years. However, the new information already approved by the Office of Management and Budget for collection in 1982 and 1983 is regarded as highly-sensitive by much of the banking industry. This is especially true for the past due loan data which the three Federal banking agency members of the FFIEC will make available to the public commencing with the reports filed as of June 30, 1983. Bankers also object to disclosure of data on their nonperforming loans for reasons of equity. They compete directly for funds, including deposits in excess of the insurance limit, with savings and loan associations; however, the public does not have access to past due loan data for these thrifts. The FDIC believes that comparable disclosure rules should apply to savings and loan associations and all other groups that are in competition with banks.

Public availability is also planned for the new Report of Condition schedules on interest-rate sensitivity and on commitments and contingencies. Here, too, bankers expressed opposition to the disclosure of these Call Report schedules. Their stance that release of such information would have an adverse competitive impact is clearly at odds with the FDIC's view that dissemination of such data to the market properly promotes the competitive posture of sound, well-managed banks.

The previous discussion of administrative actions delineated various arguments for and against public awareness of the existence of statutory enforcement actions taken by the bank regulatory agencies against individual institutions and their directors, officers or employees. The FDIC believes that the ameliorating effect that such disclosure would have on the quality of bank management outweighs the potential for harm that has been theorized but for which we find little support.

Hence, the staff has developed a proposed Statement of Policy under which the FDIC would publish in the Federal Register all final orders issued under its statutory enforcement authority. Publication of actions taken would occur on or about each order's effective date. The FDIC's termination of a previously published order would also be printed in the Federal Register. As presently drafted, this policy would become effective six months after its formal adoption by the FDIC Board of Directors.

Adoption of this policy will not only further the fundamental purpose of the FOIA, which is to broaden the public's access to government records, but will also enhance the supervisory efforts of the FDIC. Facing the specter of unfavorable disclosure, bank management may be less likely to engage in activities which could be found to be hazardous. For those few banks where the initiation of statutory enforcement action becomes necessary, awareness of final orders will allow the market, in concert with the FDIC, to exert pressure on such banks to correct the practices, conditions or violations cited therein and to attract and retain competent personnel to properly manage bank affairs.

At this stage of the drafting, the proposal's coverage is limited to insured state nonmember banks. The FDIC does not believe that other financial institutions and their directors, officers and employees should be excluded from the proposed policy and the participation of the OCC and the FRB will be solicited to facilitate uniform application of the policy to all Federally-insured banks. Other Federally-insured institutions should also be included.

Evaluate Agency and Public Data Needs

Insured banks face a multitude of reporting requirements imposed by various government agencies. The process of collecting, preparing and transmitting this information exacts a heavy burden, both in terms of time spent and expenses incurred, on each financial institution. If banks are to fulfill their reporting obligations in a satisfactory manner, it is incumbent upon the FDIC and other Federal agencies to exercise responsible behavior and review the continuing need for the reported information. The FDIC is already required to perform assessments of the practical utility of the data requested from banks at least once every three years as a result of the requirements of the Paperwork Reduction Act of 1980. The FDIC has committed itself to continue to reduce the bank reporting burden by promptly discontinuing the collection of data which is no longer relevant to its needs.

CHAPTER V

ADEQUACY OF THE INSURANCE FUND AND REVISIONS TO ASSESSMENT PROCEDURES

Page

Executive Summary V-1

Introduction V-2

Financial Operations of the FDIC V-2

Determining the Adequacy of the Deposit Insurance Fund V-3

Borrowing Authority V-8

Assessment Procedures V-8

CHAPTER V

ADEQUACY OF THE INSURANCE FUND AND REVISIONS TO ASSESSMENT PROCEDURES

EXECUTIVE SUMMARY

The conclusion of this chapter is that the Fund has been adequate to handle failed bank situations and to maintain public confidence in the banking system. In the future, the manner in which the Fund is financed and the options available to handle failed banks probably will provide sufficient flexi- bility to absorb larger losses and preserve the historical relationship to exposure. While it is theoretically possible that losses could be large enough to impair the viability of the Fund, the likelihood of this occurring is sufficiently remote to not warrant adjustment to premium rates or other actions in anticipation of a worst-case scenario.

The Fund has grown each year since its inception, and there generally has been a remarkably consistent relationship between the size of the Fund and bank deposits. This relationship has persisted for several reasons. First, there are certain "normal" relationships within the economy that tend to link the longer term growth rate of gross income to the FDIC to the growth rate of bank deposits. Second, with the exception of the years prior to 1941, and 1981-1982, there were relatively few bank failures, with an average of about 5.5 failures per year. Finally, the FDIC's considerable discretion with respect to the handling of bank failures, has tended to minimize insurance losses and has resulted in a relatively small variance in loss rates. The extent to which the future banking environment is accompanied by larger numbers of bank failures and a different loss experience will determine whether these historical relationships persist. As long as the Fund is sufficient to fund losses and meet cash needs, its adequacy is more a matter of perception than the strict maintenance of a particular relationship to bank deposits or some other measure of exposure.

The assessment/rebate system has performed well. It has the advantage of cushioning the Fund in times of abnormal losses and inhibiting excessive growth in periods of low losses. The present system, however, results in some inequities.

The following recommendations are made:

- o The percentage of net assessment income returned to insured banks in the form of a rebate should be tied to the relationship of the Fund to total domestic and foreign deposits, not to the relationship of "insured" deposits as is currently prescribed.

- The computation of assessable deposits should not include an adjustment for uncollected items (float).
- The existing fixed limit on the FDIC's borrowing authority from the Treasury should be made more flexible. It is suggested that the amount be open to negotiation between the Secretary of the Treasury and the FDIC at the time borrowings are requested.

INTRODUCTION

The purpose of this chapter is to address the issues relating to the appropriate size of the Deposit Insurance Fund and the manner in which the Fund is financed. The chapter explores whether the present assessment arrangement is likely to be adequate in the future, whether it provides sufficient flexibility to accommodate a more variable and decontrolled environment, and whether the present method of levying assessments is appropriate.

FINANCIAL OPERATIONS OF THE FDIC

From the standpoint of financial operations, the FDIC operates in a manner similar to a casualty insurance company. Premiums collected from insured entities and income from investments are used to cover operating expenses, losses, and additions to reserves (net worth). In periods where expenses and losses exceed gross income, the net worth account is used to absorb the deficit. If, over the long-run, the funding is based on a well-founded actuarial basis, premium and investment income will be sufficient to cover expenses and losses, and to maintain net worth at a level deemed appropriate to absorb unanticipated losses.

While this description more or less reflects the way in which the FDIC operates, there are certain differences. Perhaps of most importance, casualty companies generally have some notion as to their risk exposure at any point in time. Actuaries spend considerable time and effort compiling statistics on the loss rates of various classes of insured, which in turn is translated into a premium structure that is reflective of anticipated future losses. For a variety of reasons, which are presented in Chapter II, loss experience related to deposit insurance operations is not amenable at this time to similar analysis.

In terms of the sources of income to the FDIC, insurance premiums (assessments) are collected from insured banks equal to 1/12th of one percent of assessable deposits, essentially deposits in domestic offices, less an adjustment for uncollected funds. After subtracting the FDIC's operating expenses and insurance expenses and losses incurred in handling failed banks, 60 percent of the remaining assessment income is rebated to insured banks in the form of a credit which is applied to the next year's assessment. Within limits, the rebate system allows the FDIC to vary the effective premium rate to account for present losses and to increase the Fund. Net premium income retained by the FDIC is added to the Deposit Insurance Fund. Appendix D contains a more detailed discussion of the assessment procedures.

In recent years the larger source of income has been the FDIC's portfolio of Treasury securities. Only a small portion of the FDIC's balance sheet is represented by fixed assets and equity in ongoing receivership estates. The majority of assets (and net worth) represents investments in U.S. Treasury obligations.1/ Appendix E presents a more detailed description of the FDIC balance sheet and income statements.

DETERMINING THE ADEQUACY OF THE DEPOSIT INSURANCE FUND

There is no scientific way to determine the appropriate size of the Fund, either in terms of an absolute amount or in relation to some measure of exposure. The Fund has to be sufficient to cover losses and meet cash needs; beyond that, however, this basically becomes a philosophical issue which depends upon what contingencies the Fund should be expected to handle, and the perceptions of the public with respect to the ability of the FDIC to protect deposits and perhaps other bank liabilities under any "reasonable" economic scenario. From this standpoint, the Fund has been adequate in the past.

From a conceptual point of view, there are a variety of factors that should be considered in an evaluation of the adequacy of the Fund. One such factor is the relationship of the Fund to total exposure, which in some sense is a measure of the ability of the Fund to absorb losses in a worst case situation. While there are numerous problems with this type of measure, the concept has gained some degree of acceptance among those concerned with insurance matters and the general public.

Within the context of Federal deposit insurance, the relationship that probably has received the most attention is the ratio of the Fund to total "insured" deposits. As a practical matter, however, the concept of an aggregate level of insured deposits has little meaning because it is only in the case of a deposit payoff that each depositor is made whole only to the basic insurance limit. However, most bank failures have been handled by means of a purchase and assumption transaction (whereby the claims of all general creditors are transferred to an acquiring institution), or assistance has been provided to facilitate the merger of a troubled bank into a viable enterprise or, more infrequently, assistance has been provided directly to the troubled bank. In each of these cases, all general creditors were made whole. Moreover, even in the case of a payoff the available evidence suggests that in most larger banks, especially just prior to failure, many deposits above the insurance limit are either collateralized or have a potential offset against an outstanding credit.

1/ Section 13(a) of the Deposit Insurance Act requires that the funds of the FDIC not in active use in deposit insurance operations be invested only in U.S. Government securities, or obligations guaranteed as to principal and interest by the U.S.

The present system has provided de facto 100 percent liability insurance for most depositors and other general creditors in insured banks. Viewed within this context, the ratio of the Fund to insured deposits underestimates the potential exposure of the Fund, and can lead to debates that have no real significance. For example, when there are discussions concerning raising the basic insurance limit, a question regarding the increased exposure of the Fund invariably arises; if liabilities are in most cases subject to 100 percent insurance, exposure is not necessarily increased.

Table I presents the size of the Fund and its relation to total domestic deposits (essentially the current assessment base), and total domestic and foreign deposits. It should be noted that both ratios exhibit a remarkable degree of stability over time.

In terms of maintaining public confidence, the historical ratios of the Fund to exposure must be judged to be adequate. Moreover, these ratios serve as the best guide to the appropriate size of the Fund. This leads to the second criterion for assessing the Fund adequacy — is income sufficient to cover operating expenses and losses, and to contribute enough to the Fund to maintain relative stability in the exposure ratios? The data presented in Table I suggest that income has been sufficient for this purpose.

In every year since 1961, the major source of income to the FDIC has been earnings on its U.S. Treasury securities portfolio. Absent a cash need of catastrophic proportions or a precipitous decline in market interest rates, the relative importance of this source is likely to increase in the furture as the size of the FDIC's securities portfolio continues to increase.

During the past few years market interest rates have been both relatively high and higher than the growth rate in bank deposits. As a result, despite sizable insurance losses in 1981-1982, the ratios of the Fund to deposits and liabilities have continued to grow, primarily from higher interest income on the U.S. Treasury securities portfolio. The average yield on the FDIC's portfolio increased from 7.72 percent in 1979 to 10.4 percent at year-end 1982.

The future relationship between market interest rates and bank deposits will depend upon several factors. One factor is the level of real interest rates that are likely to prevail. Market (nominal) and real interest rates are linked by means of inflationary expectations. Thus, everything else equal, earnings on the FDIC's securities portfolio will be directly related to the level of real rates. In recent years, the real rate of interest probably has been high relative to the previous 25 years' average and it is probable that these high rates will be maintained at least over the short-run. At some point, however, real rates will decline, perhaps approaching the post World War II norm. Counterbalancing the positive effect of higher interest earnings accruing to the Fund, however, is a probable increase in banking activities. As interest ceilings on deposits are completely dismantled, the share of financing that bypasses the banking system will be reduced. This suggests that for some adjustment period, other things equal, growth in bank deposits

TABLE 1

EXPOSURE OF THE DEPOSIT INSURANCE FUND, 1934 - 1982

Year (December 31)	Deposit insurance fund ($millions)	Ratio of deposit insurance fund to - Total deposits in insured banks - Domestic	Domestic and Foreign
1982	$13,770.9	.89%	.75%
1981	12,246.1	.87	.71
1980	11,019.5	.83	.68
1979	9,792.7	.80	.65
1978	8,796.0	.77	.65
1977	7,992.8	.76	.65
1976	7,268.8	.77	.66
1975	6,716.0	.77	.65
1974	6,124.2	.73	.64[1]
1973	5,615.3	.73	
1972	5,158.7	.74	
1971	4,739.9	.78	
1970	4,379.6	.80	
1969	4,051.1	.82	
1968	3,749.2	.76	
1967	3,485.5	.78	
1966	3,252.0	.81	
1965	3,036.3	.80	
1964	2,844.7	.82	
1963	2,667.9	.85	
1962	2,502.0	.84	
1961	2,353.8	.84	
1960	2,222.2	.85	
1959	2,089.8	.84	
1958	1,965.4	.81	
1957	1,850.5	.82	
1956	1,742.1	.79	
1955	1,639.6	.77	
1954	1,542.7	.76	
1953	1,450.7	.75	
1952	1,363.5	.72	
1951	1,282.2	.72	
1950	1,243.9	.74	
1949	1,203.9	.77	
1948	1,065.9	.69	
1947	1,006.1	.65	
1946	1,058.5	.71	
1945	929.2	.59	
1944	804.3	.60	
1943	703.1	.63	
1942	615.9	.69	
1941	553.5	.78	
1940	496.0	.76	
1939	452.7	.79	
1938	420.5	.83	
1937	383.1	.79	
1936	343.4	.68	
1935	306.0	.68	
1934	291.7	.73	

---

[1] Foreign office data not available prior to 1974.

will be above normal. However, once that "adjustment" occurs, the FDIC expects a return to the growth path that is explained by economic aggregates.

Over the past 25 years, interest earnings have increased by a compound rate of one to one and one-half percent less than bank deposits. While this relationship may not hold over the shorter term for the reasons cited above, it may be a reasonable approximation for long-term behavior. Whatever the size of the shortfall, however, retained assessment earnings is the only other source available to stabilize the ratio of the Fund to deposits. The magnitude of this income depends on the dollar volume of deposits in the banking system (currently only domestic deposits are subject to assessment) and the magnitude of insurance losses.

In general, losses incurred by the FDIC in connection with failed banks have been modest. From 1934 to 1980, estimated losses and insurance expenses as reported by the FDIC amounted to only about $400 million.2/ This represented less than four percent of the assets of the failed FDIC-insured banks during that period and about the same percentage of gross assessments. These loss calculations, however, underestimate the true loss in that they do not adequately reflect the foregone interest earnings associated with FDIC advances to receiverships.3/ If the data are adjusted to take account of foregone interest, losses would be raised by about five percentage points, resulting in a revised estimate of about nine percent of the assets of failed banks.4/

Considering the types of assets acquired from failed banks and the often long and protracted liquidation effort that follows, losses have been modest. Under most circumstances, banks do not get to the point where they are substantially insolvent before they fail. Also, before the FDIC becomes exposed, bank stockholders and subordinated creditors must suffer total loss.

In the last two years, the FDIC incurred substantial losses in connection with assisted mergers involving failing mutual savings banks. In 1981-1982, these losses amounted to about $1.4 billion, which is comparable to the failed commercial bank loss experience of about nine percent of assets. It should be noted that in most of these transactions the FDIC did not advance cash to acquire assets. Present and projected future payments in connection with these assisted mergers were estimated when the transactions were affected and money costs were taken into account. While the ultimate costs of some of these

---

2/ These losses result primarily from the liquidation of assets the FDIC receives in transactions involving failed banks.

3/ After December 31, 1982, all cash advances made in connection with a failed or failing bank will accrue interest at the average three-year U.S. Treasury bond rate.

4/ Adjustments would have increased insurance expenses and raised the amount of assessment income retained by the FDIC. Thus, the actual treatment afforded these transactions reduced the amount of cash available for investment, and ultimately reduced the size of the Fund.

transactions will depend upon future interest rates, there is no downward bias associated with the $1.4 billion loss estimate.

Although interest rates have declined and asset depreciation of savings banks has considerably lessened, the savings bank problem has not ended. However, as long-term assets approach maturity or are paid off and portfolios are shortened, this interest rate exposure will decline in absolute terms, and even more so in relative terms (relative to the size of the institutions and a growing FDIC). Commercial banks for the most part have only limited interest rate exposure. Overall, the potential loss exposure to the FDIC from interest-rate risks in FDIC-insured banks is likely to be considerably less important in the future.

It is difficult to confidently predict future FDIC insurance losses. To some extent they will be affected by possible changes in the deposit insurance system which may provide incentives for banks to curb risks. Losses will also depend importantly on the volatility in the economy and in financial markets.

Deregulation of deposit interest rate ceilings, expanded geographic competition, and other banking market changes are likely to increase risks in banking in general. In addition, the depth of the recent recession in the United States and abroad has increased the number of problem banks, amount of loan losses, and volume of nonperforming loans, all of which are likely to increase further with a lag of one to two years after economic recovery. Thus, future FDIC losses are likely to be relatively higher than those experienced between 1934 and 1980, when they amounted to about nine percent of gross assessments. However, the FDIC expects these losses to average considerably less than the 70 percent of gross assessments experienced in 1981 and 1982. While FDIC losses will depend on the number and size of future bank failures, it is important to keep in mind that FDIC experience suggests that these losses will run from nine to ten percent of the assets of failed banks.

The FDIC could sustain a relatively high loss rate in the future and, nevertheless, net assessment income would still add sufficiently to the growth of the Fund to cover any shortfall (one to 1.5 percent historically) between interest income and deposit growth. At present, the Deposit Insurance Fund is about 0.80 percent of the deposit assessment base. Gross assessments of 1/12th of one percent of deposits equal about ten percent of the Fund. The following calculations indicate that even if insurance losses average 40 percent of gross assessment income in the future, net assessment income would still add two percent a year to the Fund:

Assessments in basis points of assessable base	8.33
FDIC operating expenses	- .90
Loses (40%)	-3.33
Net before assessment credit	4.10
Credit (60%)	-2.46
Retained by FDIC	1.64

As a percentage of the Fund = $\frac{1.64}{0.80}$ = 2.05%

Under more extreme circumstances, the Fund could absorb considerable loss for a period of a year or two without seriously compromising its adequacy. The rebate system in essence places 60 percent of losses directly with insured banks; this provides a cushion to the Fund in absorbing insurance expenses. Further, if operating expenses and losses exceed gross assessment income, the excess is carried forward to subsequent years and is charged against gross income in the same manner as current losses. Moreover, current law ties the proportion of net assessment income returned to insured banks to the relationship of the Fund to total exposure.[5/] Thus, there may be situations where the ratio of the Fund to exposure declines, and perhaps where the size of the Fund actually declines, but the workings of the system tend to accelerate the rate of income accumulation until historical relationships have been restored. Nevertheless, there is some level of loss that would be judged to impair the viability of the Fund; if this should occur, it would be necessary to re-evaluate the current method of funding the FDIC.

The final factor to consider in evaluating the adequacy of the Fund is the ability to meet the potential requirements for large cash needs (liquidity). In most failed bank situations the ultimate loss is normally a reasonably small percentage of assets; however, there often is a need for an initial cash outlay equal to several times the loss. In the typical "clean bank" purchase and assumption transaction, for example, the acquiring bank will assume all nonsubordinated liabilities, and will purchase some assets which normally include banking house, cash, securities (at market) and some loans. Cash sufficient to make up the difference between acquired assets and assumed liabilities, less the premium paid by the acquiring bank, is advanced by the FDIC. Depending on the size of the failed bank and the amount of assets passed to the acquirer, the need for immediate cash could be sizable.

In addition to following an investment strategy that has explicitly considered anticipated cash needs, the FDIC has available, and has used, various techniques to minimize initial cash outlays. One of the earlier examples was in connection with the failure of Franklin National Bank of New York, where the FDIC assumed the $ 1.7 billion borrowings from the Federal Reserve Bank of New York, and repaid the advance over a period of three years. More recently, most of the assistance provided to facilitate the merger of failing mutual savings banks has taken the form of future cash payments based on the relation of market interest rates and the average yield on the declining balance of assets acquired. In a few cases, the FDIC has provided longer-term promissory notes in lieu of immediate cash.

It has not been always possible or desirable to substitute future payments for cash up-front, but the FDIC has had considerable success in minimizing

---

5/ The Depository Institutions Deregulation and Monetary Control Act of 1980 authorizes the Board of Directors of the FDIC to make adjustments to the assessment credit to maintain the Fund between 1.25 and 1.40 percent of estimated insured deposits, and mandates adjustments when the Fund falls below 1.10 percent and exceeds 1.40 percent of insured deposits.

immediate cash outlays where appropriate. Additionally, the FDIC is currently experimenting with ways to induce acquiring institutions to purchase more assets than historically has been the case. The United American Bank, Knoxville, Tennessee, transaction, where all assets were passed to the acquiring bank under a guaranty from the FDIC, is a type of transaction that may be followed more frequently in the future.

BORROWING AUTHORITY

If an emergency situation were to develop, the FDIC does have the authority to borrow up to $3 billion from the U.S. Treasury. This authority has never been used, and it is only in an extreme situation that this liquidity would be needed. There is logic, however, to revising the limit to reflect the growth of the Fund as well as the banking system, inasmuch as the current limit was legislated in 1947. At that time, the borrowing limit exceeded the Fund and represented approximately 1.9 percent of domestic deposit liabilities; at year-end 1982, this amount was less than 25 percent of the Fund and only 0.18 percent of domestic and foreign deposits. The FDIC does not recommend that the limit be increased to restore the coverage existing in 1947. Nevertheless, the borrowing limit should be more reflective of current exposure and the current size of the Fund, both because of the implications for public confidence and to provide a safety valve in the case of a banking crisis. To provide flexibility and to limit the statutory exposure of the Treasury, the FDIC recommends that the borrowing authority be whatever amount may be mutually agreeable to the Secretary of the Treasury and the FDIC at the time any borrowings are requested.

The conclusion that flows from this discussion is that the Fund has been adequate to handle failed and failing bank situations, and to maintain public confidence in the banking system. The way in which the Fund is financed provides sufficient flexibility to permit absorption of larger losses while preserving the historical relationship between the Fund and exposure. It is possible that losses could become large enough, or persist at an abnormally high rate over a long enough period of time to endanger the Fund or undermine public confidence in the FDIC. The occurrence of such an event does not appear likely at this time, and therefore it would be premature to adjust premium rates or take other actions in anticipation of a disaster scenario. In short, the current system works well in terms of generating sufficient revenue to handle losses and maintain public confidence in the system, and there are no reasons to believe that it will not continue to operate as well in the future.

ASSESSMENT PROCEDURES

As indicated in the preceding section, the current assessment system is basically sound and, in all probability, will meet the future funding requirements necessary for FDIC operations. Perhaps one of the most desirable features of this system is the rebate mechanism, whereby losses and expenses are shared by the FDIC and insured banks on a 40-to-60 percent basis. This has provided a cushion to the Fund in periods of abnormal losses, and a means to constrain excessive growth during periods of small losses.

The assessment base currently includes only deposits in domestic offices of insured banks. There may be merit to expanding this definition to encompass deposit liabilities in foreign offices of U.S. banks and International Banking Facilities. As discussed earlier, in situations where the FDIC uses a purchase and assumption transaction to handle a bank failure, these deposits are *de facto* 100 percent insured. Moreover, many foreign deposits are explicitly insured under existing law. Furthermore, if the FDIC institutes a policy of handling all or a majority of failed banks by means of a coinsurance approach, as discussed in Chapter III, explicit deposit insurance coverage of foreign and IBF deposits may act as a stabilizing influence. The FDIC considers current assessment income sufficient to meet insurance needs. Thus, if insurance coverage and assessments are expanded to include foreign office and IBF deposits in the future, it would be appropriate to reduce the assessment rate to offset the resulting increase in assessment income.

The International Banking Act of 1978 increased deposit insurance coverage and the assessment base by establishing procedures for the FDIC's insuring certain U.S. branches of foreign banks. Such insurance poses problems because the FDIC is not in a position to assess the conditions of the overall banking organization or to prevent the shifting of assets out of U.S. branches in times of financial difficulties. Necessary enforcement procedures by the FDIC may sometimes be impeded by legal and political problems. For these and other reasons the FDIC believes a reconsideration of the International Banking Act provisions relating to the insurance of deposits in domestic branches of foreign banks may be in order. In several areas of this study, recommendations designed to encourage risk restraint by banks appear to have no applicability to foreign branches. For example, it would be difficult to apply a risk-related premium system to a branch and it would be difficult to attain satisfactory disclosure unless it covered the entire banking organization. These considerations lend additional support for reevaluating the insurance of domestic branches of foreign banks.

There are two technical aspects of the assessment process that are in need of revision at this time. The first deals with the adjustment to deposits for uncollected items. The second relates to the percentage rebate based on the ratio of the Fund to "deposits."

For purposes of determining assessable deposits, banks are permitted to reduce total deposits to reflect the uncollected items (float) on their balance sheets (see Appendix D for a more detailed discussion). The stated rationale for allowing this adjustment is to eliminate double counting in determining the assessment base. Float is a creation of the clearing process, whereby an item (a check) is often credited to an account at the receiving bank prior to being debited by the bank upon which the item is drawn. Basing assessments on unadjusted total deposits, therefore, would assess these uncollected items twice, once at the receiving bank and again at the issuing bank.

There are several reasons why this adjustment is unnecessary and, in terms of the present procedures, inequitable. In the first place, for the purpose of deposit insurance coverage for an individual bank, unadjusted deposits is the unit insured, not deposits adjusted for float. If a bank is closed, booked uncollected items are processed and added to the cash account, while items presented for payment are returned as being uncollectible. Thus, the exposure assumed by the FDIC is accurately reflected by the deposit balances on the books of the bank at the time of closing.6/ Secondly, the current procedures permit a fixed percentage deduction for "demand" balances (16-2/3rd percent) and "time and savings" balances (one percent). This practice tends to reward those banks with a relatively small volume of clearings and penalize those banks with a large volume; this is clearly an inequitable treatment of insured institutions. Finally, the Federal Reserve Board has announced its intention to adopt rules and procedures designed to reduce the volume of float in the system and, more recently, has introduced some changes in the clearing process to accomplish this goal.

For these reasons, the FDIC recommends that the FDI Act (Section 7(b)(6)) be amended to delete the permissibility of an adjustment for float to total deposits for assessment purposes. This action will increase the assessment base moderately. Based on current data, the affect on assessment income would be minimal, amounting to about $60 million per year.

The second recommendation relates to the statutory provision that ties the proportion of net assessment income rebated to the relationship of the Fund to "insured" deposits. As argued earlier, "insured" deposits is not a meaningful measure of exposure of the Fund, and on these grounds the FDIC recommends that Section 7(d)(1) of the FDI Act be amended to relate the assessment rebate to the ratio of the Fund to domestic and foreign deposits. The ratios that trigger a change in the rebate percentage currently in the Act, of course, would have to be changed to reflect the expanded base. Based on the historical relationships, an upper limit of 1.0 percent and a lower limit of 0.60 percent appear to be reasonable.

6/ This ignores unbooked items and unposted debits and credits. Normally, the amount involved in these categories is minimal.

CHAPTER VI

MERGER OF THE DEPOSIT INSURANCE FUNDS

Page

Executive Summary VI-1

Introduction VI-2

Arguments for Merging the Funds VI-2
    Similarities of Insurers VI-2
    Insurance Premiums VI-2
    Regulatory and Supervisory Powers VI-3
    Insurance and Supervision VI-4
    Similarities of Insured Institutions VI-4
    Risk Diversification and Strength of the Funds VI-5
    Changes in Charters and Interindustry Mergers VI-7
    Reporting and Surveillance VI-8
    Separation of Insurance From Chartering and Regulation . . VI-8

Arguments Against Merging the Funds VI-9
    Conflict With Other Public Policies VI-9
    Loss of Industry Orientation VI-10
    The Question of Equity VI-10
    Public Confidence VI-10

Merging the Funds VI-10
    Single Pool VI-11
    Separate Pools VI-11
    Phase-in VI-12

Supervisory Framework VI-12

CHAPTER VI

MERGER OF THE DEPOSIT INSURANCE FUNDS

EXECUTIVE SUMMARY

Recent changes in the financial-services industry have created a more open and competitive environment for banks and thrifts and have thrust them into direct competition with each other. Not only have thrifts acquired powers previously reserved for commercial banks, they have been granted authorities which go far beyond those ever envisioned when Congress crafted our current insurance and regulatory systems 50 years ago. For example, a diversified corporation controlling a new savings bank charter issued by the Federal Home Loan Bank Board ("FHLBB") is free to engage in virtually any lawful activity, make any type of investment it wishes, and own controlling interests in almost any other company it chooses, any place in the world.1/

Separate regulatory and insurance systems for savings and loan associations and banks are becoming intolerable from the standpoint of competitive equity among like firms and from the standpoint of fostering the most effective and efficient regulatory system and the strongest possible insurance system. The FDIC suggests a number of reforms in this chapter, including:

- Merging the Federal Savings and Loan Insurance Corporation ("FSLIC") into the FDIC;2/
- Granting the FDIC authority to require reports from, take enforcement actions against, and conduct examinations of all Federally-insured banks and thrifts and their affiliates;
- Removing the FDIC from the applications process and all other regulatory functions not directly related to safety and soundness; and
- Establishing a separate, single agency for chartering and regulating all Federal banks, thrifts, and holding companies.

1/ Vartanian, Thomas P. and Hawke, John D., Jr. "It Sounds Like a Banker's Fantasy, But It Isn't," The American Banker, April 13, 1983, Vol. CXLVIII, No. 72.

2/ Consideration was given to including the National Credit Union Administration and its insurance fund (the "NCUSIF") in the reorganization, but this was rejected, at least at this time, as unnecessarily burdensome given the relatively small size of the NCUSIF and the average credit union and the limited direct competition between banks and savings and loan associations, on the one hand, and credit unions, on the other. The other reforms recommended in this study will be difficult enough to implement without including the NCUSIF and some 17,000 Federally-insured credit unions in a reorganization.

INTRODUCTION

This chapter discusses the insurance and supervisory systems for banks and savings and loans and the most often cited arguments for and against a reorganization of these systems. On balance, the arguments show the necessity for a more rational system which would provide uniformity of deposit insurance, a coordinated system of supervision, and greater flexibility in dealing with troubled or failed banks and thrifts.

ARGUMENTS FOR MERGING THE FUNDS

Similarities of objectives and functions for the deposit insurance agencies and a growing similarity in banks and thrift institutions all argue that a single fund is a logical alternative to the present framework. The future of the financial services industry will require a larger, better-diversified insurance fund and greater flexibility in dealing with troubled or failed institutions, particularly cross-industry takeovers. Merging the funds will also provide for less public confusion and greater public confidence in the deposit insurance system, and foster more uniformity of supervision. An additional important reason is that of separating the role of deposit insurance from chartering and regulation.

Similarities of Insurers

In basic form, the FDIC and FSLIC have very similar powers and functions. Both, either directly or through entities to which they are tied, exercise some control over the entry of an institution to their respective industries, regulate and supervise constituent institutions' activities, and oversee the closing and liquidation of a troubled or failed institution. Likewise, they assess deposit insurance premiums on constituent institutions to support these functions, but primarily to support an insurance fund to maintain the objectives of stability of the financial system and depositor protection.

The FSLIC is distinguished from the FDIC in that it has no separate governing board; it is governed by the FHLBB. Although the FSLIC is technically separate from the FHLBB, it has little administrative apparatus of its own and relies on the FHLBB for the services of examiners, legal staff, etc.

Insurance Premiums

Both agencies levy premiums (assessments) based on "domestic deposits." The FDIC has a statutory rate of 1/12th of one percent. The FDIC is required to credit 60 percent of the assessment to insured banks after deducting its operating expenses and insurance losses for the year. The "rebate" may be decreased to 50 percent in order to maintain the fund above 1.10 percent of insured deposits and increased to 100 percent if the fund exceeds 1.40 percent of insured deposits.

The FSLIC also has a basic assessment rate of 1/12th of one percent computed by reference to "all accounts of the insured members of the institution." This contrasts with the FDIC's assessment formula, which is complex by comparison. In addition to its basic assessment rate, the FSLIC can ask for an emergency assessment up to an additional 1/8th percent of insured deposits if the fund falls below 1.0 percent of insured deposits. The FHLBB may also require FSLIC insured institutions to make deposits in the FSLIC's fund, up to one percent of total industry deposits, to prevent the depletion of the FSLIC fund. If the FSLIC fund rises above two percent of insured deposits, the FSLIC does not charge any assessment.

The following table summarizes the two assessment schemes:

	Basic Rate	Supplemental	Rebate	Statutory Ratio	Borrowing Authority
FDIC	1/12%	None	Yes	1.1 - 1.4%	$3 Billion
FSLIC	1/12%	Up to 1/8%	No	1.0 - 2.0%	$750 Million

One benefit of merging the two funds would be to unify assessments. As shown in the table above, the present assessment schemes begin with the same basic rate, but vary widely after that. The FDIC scheme defines assessable deposits differently than insured deposits.[3] The FSLIC assessment scheme is simple and straightforward by comparison, using "insured accounts" as a base.

Regulatory and Supervisory Powers

While the two insuring agencies have similar regulatory and supervisory powers, distinctions exist in the way the agencies operate. The FDIC, while insuring approximately 14,700 commercial and mutual savings banks, is the Federal supervisor over only two segments -- some 8,900 insured state-chartered commercial banks which are not members of the Federal Reserve System ("FRS") (nonmember banks) and 300 insured mutual savings banks. The approximately 4,500 nationally-chartered banks are supervised by the Office of the Comptroller of the Currency (OCC), and some 1,000 insured state-chartered banks which are members of the FRS (member banks) are under the primary Federal supervision of the Federal Reserve Board (FRB).

The FDIC does, however, review all bank and bank holding company examination reports, and monitors all FDIC-insured institutions and bank holding companies (bank holding companies are supervised by the FRB). Further, by statute and through agreements with the FRB and OCC, the FDIC conducts joint and/or concurrent examinations of selected banks for which it is not the primary Federal supervisor and bank holding systems which include nonmember banks. By statute, all national banks and other banks which are members of the FRS must have Federal deposit insurance, and state laws generally require Federal deposit insurance as a condition to granting a charter.

---

[3] Deductions are allowed for (1) cash items held by a bank drawn on itself; (2) one percent of "adjusted time and savings deposits"; and (3) 16-2/3 percent of "adjusted demand deposits." See 12 U.S.C. 1817(b).

The FSLIC has no examination personnel. Its parent organization, the FHLBB, directly supervises approximately 3,300 institutions which are nearly evenly split between Federal and state-chartered savings and loans, with a few Federal savings banks (a recent phenomenon which results when a state-chartered savings bank converts to a Federal charter). The FHLBB also supervises savings and loan holding companies (companies controlling FSLIC-insured savings and loans).

The FHLBB is the chartering authority for Federal savings and loans. Similar to the FDIC insurance requirements for nationally-chartered banks, all Federally-chartered savings and loans and savings banks are required to have Federal deposit insurance. State-chartered savings and loans must volunteer for insurance. All FSLIC-insured institutions belong to the Federal Home Loan Bank System (the "System"), and a member cannot leave without relinquishing its insurance.

Both the FSLIC and FDIC have direct examination and supervisory authority or a close and continuous link to those agencies with primary supervisory responsibility. It is that authority and linkage which should be preserved, not the structure of the of the insurance agencies.

Insurance and Supervision

More important than the similarities and differences of assessment, examination and supervision is the relationship between insurance responsibility and supervisory powers. The resulting insurance agency, however constituted, must have the authority to prescribe the conditions for insurance coverage, to fix the premiums levied, to use examination and surveillance techniques, and take enforcement action to safeguard its function and insurance fund. Regulatory and supervisory activities unrelated or marginally related to insurance such as routine applications need not be part of the insurer's responsibilities, but there should be no barriers implicit or explicit to the insurer's access to information and authority to discharge its responsibilities.

Similarity of Insured Institutions

During recent years thrift institutions have acquired powers which point toward the emergence of a homogeneous financial-services industry. All banks and thrifts can now offer "demand deposit" accounts and commercial loans.4/ In addition, depositors often do not distinguish between institutions, and merging the deposit insurance funds would be in keeping with industry trends and create a less confusing framework to the public. Insurance coverages and procedures for handling failed institutions would be unified. This will be particularly important if the reforms recommended in this report, such as risk sharing by larger creditors, are to be implemented.

4/ This does not include certain "nonbank banks" which have divested themselves of or do not exercise the power to make commercial loans so as not to be defined as a bank under Section 2(c) of the Bank Holding Company Act.

Events of the past two years have piqued the public's attention with respect to deposit insurance. Questions have arisen in the media regarding the ability of any one agency to handle the problems in any particular segment of the industry, particularly the thrift industry. Merging the FSLIC and FDIC insurance funds is one way of increasing public confidence by providing a larger fund with greater diversification of risk and at the same time reducing the likelihood of direct government subsidization.

Risk Diversification and Strength of the Funds

Although the term "depository institution" implies a basic similarity among all institutions that accept deposits, risk exposures currently differ for banks and thrifts. Both are exposed to managerial incompetence and self-dealing but banks, because of the better balance between the maturity structure of their assets and liabilities and greater flexibility in adjusting their interest rates to money and capital market conditions, have minimal intermediation risks. Risks in commercial banks are centered in loan losses and the escalating level of bank and nonbank competition.

Thrifts, on the other hand, as an industry do not show significant loan losses; their primary risk at present is one of interest rate. Interest paid by thrifts grew from 75 percent of operating revenues in the mid-70s to 85 percent in 1980, and 97 percent in 1981. The corresponding shrinkage in gross margins, from which operating expenses must be paid, depleted reserves (net worth) to dangerous levels and resulted in the failure of many institutions.

Table I indicates the financial positions of all banks and savings and loans each agency insures for the period 1974 through 1981. For the last five years, the most recent for which data are available, the equity (net worth) to assets ratio for banks has been stronger. The figures for 1980 and 1981 for FSLIC insured institutions reflect the severe impact high interest rates and disintermediation have had on thrifts due to their extreme vulnerability to interest-rate risk.

Table I

Condition of Insured Institutions

	FDIC INSURED		FSLIC INSURED	
	Income/ Assets	Net Worth/ Assets	Income/ Assets	Equity/ Assets
1981	.61%	7.0%	(.73)%	4.2%
1980	.69	6.9	.13	5.4
1979	.74	6.9	.67	5.6
1978	.70	6.8	.82	5.5
1977	.65	6.9	.77	5.5
1976	.64	7.1	.63	5.6
1975	.64	7.0	.47	5.8
1974	.65	7.4	.54	6.2

Owing to the similarities between savings banks and savings and loans, the 1980 and 1981 figures for FDIC-insured institutions are distorted as savings bank performance lowered that of the group. The table below shows income/assets for commercial banks, savings banks, and savings and loans for 1980 and 1981.

	Commercial Banks	Savings Banks	Savings and Loans
1981	.77%	(.93)%	(.73)%
1980	.80	(.17)	.13

By September 30, 1982, the net worth/assets ratio for all FDIC-insured mutual savings banks had declined to 5.2 percent and the net worth/assets ratio for all insured savings and loans had declined to 3.4 percent. By midyear 1982, some 500 savings and loans had net worth/assets ratios below the two percent minimum required by the FHLBB.[5]

Merging the deposit insurance funds would have the effect of diversifying the present risks. That is, an industry systemic risk such as interest-rate risk, to which thrifts have been and still are vulnerable, would be less likely to jeopardize a combined fund.

Table II shows the respective fund balances and the ratio of each fund to insured deposits for the years 1974 through 1982. Notwithstanding a statutorily prescribed ratio and rebate (see the table on page VI - 3 of this chapter), the FDIC's fund to insured deposit ratio is higher than that of the FSLIC.

TABLE II

Size of the Respective Funds
(In Millions)

	FDIC Fund Balance	FDIC Fund/ Ins. Dep.	FSLIC Fund Balance	FSLIC Fund/ Ins. Dep.
1982	$13,771	1.21%	$6,418	1.16%
1981	12,246	1.24	6,301	1.23
1980	11,019	1.16	6,462	1.29
1979	9,792	1.21	5,848	1.27
1978	8,795	1.16	5,328	1.26
1977	7,992	1.15	4,873	1.29
1976	7,268	1.16	4,480	1.37
1975	6,716	1.18	4,120	1.48
1974	6,124	1.18	3,791	1.60

---

[5] Michael J. Moran, Thrift Institutions in Recent Years, Federal Reserve Bulletin, December 1982.

Table III shows the size, maturity structure, and market value of investment portfolios of each of the funds as of December 31, 1982.[6] Federal statutes require that each of the agencies invest solely in direct obligations of the U.S. Treasury or securities fully guaranteed by the United States.

TABLE III

Investment Portfolios of the Insurance Funds
(In Millions)

	Weighted Avg. Maturity	Book Value (Millions)	Market Value (Millions)	Depreciation (Millions)	Depreciation Book Value
FDIC	2.7 yrs.	$13,252	$13,320	$(68)	(0.5)%
FSLIC	4.9 yrs.	5,325	5,017	308	5.8

( ) Denotes appreciation.

Based on the maturity structure of each of the portfolios, a merging of the funds could provide some flexibility with respect to liquidity needs, which in turn could enhance portfolio performance.

Changes in Charters and Interindustry Mergers

Beginning in 1978 several state-chartered insured mutual savings banks in New York converted to Federal savings banks. In order to facilitate these charter conversions, the FDI Act was amended to provide that FDIC would indemnify the FSLIC against certain losses incurred by the banks prior to conversion.[7]

Beginning with all applications for charter conversion filed after October 15, 1982, the indemnification agreement between the FDIC and FSLIC became no longer applicable.[8] Title I of the Garn-St Germain Depository Institutions Act of 1982 (Garn-St Germain Act) provides that the FDIC will insure any state-chartered mutual savings bank converting to a Federal charter until that bank shall be insured by the FSLIC. In effect, the Garn-St Germain Act has created a situation whereby institutions chartered by the FHLBB are insured by the FDIC. By passing that Act, Congress appears to have set the stage for a single fund insuring all banks and savings and loans regardless of charter or class.

In addition to charter changes, interindustry mergers can be expected to increase as banks and thrifts seek to gain access to each other's markets. A well-publicized example is the Citicorp, N.Y. acquisition of Fidelity Federal

---

[6] Information supplied by the portfolio manager for each of the funds.

[7] See Section 26 of the FDI Act, 12 U.S.C. 1831(c).

[8] See Title I, Sec. 112, of the Garn-St Germain Depository Institutions Act of 1982.

Savings and Loan of San Francisco. As interindustry mergers gain wider acceptance, the rationale for a combined fund will continue to grow.

Moreover, the fractionalized supervisory framework will become more inefficient and less effective in dealing with organizations which include both banks and thrifts. The FDIC, for example, is already experiencing difficulties in monitoring banks which are affiliated by virtue of common ownership or control with savings and loan associations. Maintaining separate insurance funds and regulatory systems in light of what has taken place in the financial-services industry with respect to charter conversions, interindustry mergers and applications would appear to have already rendered the present system outdated.

Reporting and Surveillance

All Federally-insured commercial and mutual savings banks are required to submit periodic financial reports. With the expanded powers granted thrifts, future activities and reports should closely resemble those of banks. Merging the funds and reorganizing the Federal regulatory structure would have benefits in terms providing for uniform reporting requirements and improved data for research and analysis. Minimum data base standards could be established for all reporting institutions and the data made available to chartering agencies. Surveillance systems would likewise be combined and information centralized.

The FDIC's experience with state supervisors in this area has been successful and could be expanded. Forty states now use FDIC reporting forms (Reports of Condition and Income), and 17 states have computer terminal access to the FDIC's data base. New York State has abolished financial reporting for commercial and mutual savings banks as a result of its participation in this program.

Separation of Insurance From Chartering and Regulation

The present system whereby chartering, regulation and supervision are used to promote all aspects of an industry (individual institutions, housing and depositors), while at the same time these vehicles are used to protect an insurance fund, involves inherent conflicts. A consequence could be the subordination of safety and soundness considerations to those of promotion. The responsibility of an insurer is, and should be, singular -- stability of the system through the safe and sound operation of individual institutions and the prompt resolution of problems.

There frequently is, and should be, a healthy tension between the insurance and regulatory functions. The best way to achieve this is through a legal separation of the agencies performing these distinct functions. While having the chartering and insurance functions housed in a single agency provides flexibility for dealing with crises, such as have been experienced in the thrift industry during the past two years, it removes the discipline provided by a system of checks-and-balances. During the past two years, the FDIC has handled more than 60 bank and thrift failures. These failures were dealt with swiftly and effectively, notwithstanding the absence of a chartering power. Indeed, the fact that the handling of those failures was subjected to review by a separate chartering authority imposed an important discipline on the insurer with respect to both identifying and resolving the problems.

ARGUMENTS AGAINST MERGING THE FUNDS

The arguments cited against merging the deposit insurance funds include potential conflict with other public policy objectives, such as convenient and adequate sources of funds for housing; loss of industry orientation; the proposition that stronger segments should not be asked to support or subsidize weaker ones; and the fear that a merger could shake public confidence.

These arguments against merging the deposit insurance funds are based on fears or perceptions founded in historical thought or evidence and fail to adequately consider the current and future financial-services industry. Prospective analysis would argue that the present system could be better structured and equipped.

Conflict with Other Public Policies

Raising the argument that merging the deposit insurance funds would conflict with other public policy objectives confuses the goals of deposit insurance with other public policy goals. The issue is whether a combined fund will be able to deal with future or potential failures of banks and thrifts. Homeownership and home construction will be better served if the fund has greater resources, thereby strengthening public confidence in both banks and thrifts. In addition, to argue that deposit insurance, or the deposit insurance agencies, are in and of themselves direct instruments for the attainment of other goals fails to recognize the paramount objective of financial stability.

In order for funds to be available for housing, business development, and other financial needs public confidence in the financial system must be maintained and even enhanced. Merging the funds would achieve just that goal. While the present supervisory and insurance framework may have been appropriate when established, the rationale for continuing that arrangement is lost in today's environment. Promotion of the housing industry is now accomplished in ways -- tax benefits, developed secondary markets, mortgage companies -- unrelated to deposit insurance. Moreover, promotion of the housing industry is better served by providing a stable flow of funds to the mortgage market and is being accomplished through efforts to deregulate the liability side of thrifts' balance sheets.

Deposit insurance has helped provide a stable financial environment and must continue in that role. The relationship betweeen insurance and stability, which has worked through the 50 years of deposit insurance, needs now to be reviewed and strengthened; merging the deposit insurance funds will not disrupt, but reinforce, that relationship.

Loss of Industry Orientation

This argument is raised within the context of having an insurance agency which is properly attuned to the problems and changes occurring in the industry. As discussed earlier, the industry has changed. As distinctions in product lines blur, geographic barriers erode, and charter conversions, interindustry mergers and affiliations occur there is a rapid breakdown in the argument that an industry-oriented insurance system is necessary, and even greater reason to integrate the deposit insurance systems. The evolving industry, which is being fostered through efforts aimed at deregulation, is rapidly outpacing the present insurance and supervisory framework.

The Question of Equity

One of the more vocal arguments against merging the deposit insurance funds, particularly from banks, is that of equity; that is, should commercial banks be asked, or required, to support troubled savings and loans. First of all, assessments paid by banks in the past are part of the Fund, which if dismantled, would revert not to the banks, but to the Treasury. As for the future, two points are noteworthy when considering this argument. First, fund consolidation could be phased in -- say within five years of merging the agencies -- to provide adequate lead time for the insuring agency to develop a risk-related insurance scheme (discussed in Chapter II). Under a risk-related system strong banks will not be supporting weak savings and loans any more than strong savings and loans will be supporting weak banks. Second, as thrifts exercise newly-acquired powers and institutions become even more similar, the insurance risks will track each other more closely. Thus, any problems of equity can be handled through a proper structuring of the merger during the transition period of the financial-services industry.

Public Confidence

One argument against merging the deposit insurance funds is that it could shake public confidence in the deposit insurance system. This argument is weak at best, and a more persuasive point could be made that public confidence in the industry would be enhanced. The public could look to a larger fund (over $20 billion), which would protect all insured deposits in all depository institutions. Moreover, such a system would be less confusing and disruptive. Depositors need not be concerned with the relative strength of a particular fund or the way in which its coverages or procedures differ from another fund.

MERGING THE FUNDS

A merger of the funds could be accomplished by either creating a new deposit insurance agency for savings and loans and banks, or moving the insurance function under one of the present organizations. Creating a new organization would seem an unnecessary and disruptive approach, and several factors strongly suggest that merging the FSLIC into the FDIC is the better approach:

- o The FDIC is by far the larger and stronger fund and has the greatest name recognition.

- The FDIC has experience with examining and supervising thrifts and evaluating consumer-oriented operations by virtue of its authorities over mutual savings banks. The FSLIC has no equivalent experience in dealing with commercial banks.

- The FDIC presently insures over 80 percent of the number and 67 percent of the aggregate insured deposits of all Federally-insured banks and savings and loans.

- The FDIC maintains an experienced Liquidation Division. At present, the Division is managing over 100 open liquidations in 34 states, the Virgin Islands, and Puerto Rico, with approximately 50,000 assets having an aggregate book value of some $2.2 billion.

- As an operating arm of the FHLBB, the FSLIC has almost no administrative apparatus.

The resources of the FSLIC could simply be consolidated with those of the FDIC resulting in a single pool of funds. Alternatively, the two funds could be kept separate under a common management, with bank-derived funds for bank-related problems, and S&L-derived funds for S&L-related problems. A third, and recommended, approach would be to bring the funds together under a common management, and phase in the merger of the funds.

Single Pool

The reserves of the FSLIC could be merged into the FDIC's with the resulting fund treated as a single unit and borrowing authorities each of the funds has could be reevaluated and consolidated. Cost savings would be realized by having administrative expenses of only one fund and investment portfolio.

One important issue related to risk-based assessments should be mentioned here. As indicated earlier, risk of failure in each type of institution is, in some respects, quite different. A risk-based assessment scheme developed under a unitary fund approach would need to be sympathetic to these differences so as not to unduly penalize one segment of the industry for high risks in another.

Separate Pools

The reserves of the FSLIC could be brought together under the management of the FDIC, but maintained and reported separately. The borrowing authorities each of the present funds has with the Treasury could be maintained separately to support the different pools. Each pool could serve as the basis for assessments on the institutions that contribute to it. To the extent (if any) that the FSLIC now has different investment powers from FDIC those differences could be retained. One pool would presumably be able to lend money to the other, enhancing portfolio performance by easing liquidity considerations. In addition, the same management cost savings attendant to a single pool approach could be realized.

The separate pools approach may also be the easiest one to accomplish. The existing accounts of the FSLIC and FDIC could be maintained, and banks and S&Ls could continue to be assessed in the familiar manner. This would not rule out the use of a risk-based assessment scheme, but could facilitate the development of customized schemes for each segment.

Phase-in

The funds could be brought together immediately under a common management and then be completely merged at a later date, say five years. As thrifts exercise more banking powers and portfolios come to resemble those of commercial banks, their risk of failure would more closely track that of banks, and the present assessment system could be made uniform.

A phased in merger achieves the same advantages as each of the other approaches with respect to reducing overhead (common management of investments) and allows for the gradual change in the present assessment system or the development of a workable risk-based scheme.

SUPERVISORY FRAMEWORK

A merger of insurance funds has implications for the structure of the supervisory framework and should be viewed as part of a comprehensive plan to more rationally define the Federal insurance and regulatory process. Reorganizing the Federal regulatory process, like merging the funds, could result in a structure similar to that now in place, or one more streamlined which would call for the combining of the chartering and regulation of Federal banks and thrifts. The primary supervision of insured institutions would be retained by the chartering agency.

The Federal financial regulatory structure could be consolidated to combine the functions of the FHLBB, FRB and OCC into a single agency. That agency should be governed by a board or panel and be independent of any other Federal agency so as to eliminate the potential for conflict. That agency would issue charters; act on corporate applications; and supervise all Federally-chartered banks and thrifts and holding companies. These functions would remain with the states for state-chartered banks and thrifts.

The FDIC would have the authority to conduct examinations, require reports, and take enforcement actions, although it would focus its attention on problem and near-problem institutions. The FDIC would not have regulatory authority with respect to branches, mergers, trust powers and the like. An examination could be made by the FDIC whenever necessary to determine the condition of an institution for insurance purposes. Under this program, the FDIC would concentrate on financial institutions with safety and soundness problems (those rated 3, 4 or 5 under the CAMEL rating system) and examine well-rated institutions (those rated 1 or 2) infrequently -- under a sampling program which would cover perhaps ten percent per year. The examination of a portion of well-rated institutions would provide the FDIC with information to judge the effectiveness of the chartering agencies' supervision and rating systems, provide training for new examiners, and diminish the automatic assumption that an institution is in trouble because of the FDIC's presence.

Reorganizing the Federal regulatory framework would result in administrative cost savings in the form of reduced legal, research and support staffs, and consolidated regional offices. Examining staffs would remain at or very near current levels for the immediate future. With some 18,000 Federally-insured banks and savings and loan associations, including 12,000 which are state-chartered, the current field staffs would be necessary to support those states which are not yet able to meet the increased demands a reorganization would place on them.

The overall supervisory structure that might be formed as a result of the reorganization of the Federal regulatory system has implications for the proper role of the FRB. In general, the issue is whether the regulation of banks and bank holding companies is necessary to conduct monetary policy. The argument that the FRB needs general supervisory authority over 1,000 commercial banks (out of a total of some 14,400) and needs to regulate and supervise bank holding companies to augment or enforce monetary policy is not persuasive. Indeed, many informed observers perceive the potential for serious conflicts between bank supervision and the conduct of monetary policy.

Tools of monetary policy (open-market activities, reserve requirements, and operation of the discount window) do not require that the FRB directly supervise banks or bank holding companies. The basic need to carry out these activities is information. Reorganizing the insurance and regulatory functions would enhance that information base.

The FRB could continue to have access to bank data and information through representation on the Board of Directors of the FDIC and the new regulatory agency and, through this, would gain more direct access to data on other financial institutions; an increasingly significant factor as thrifts begin exercising more bank-like powers. The FDIC would thus have a three-member Board: two appointed members, one serving as chairman and the other as vice chairman, and an ex officio member from the FRB.

Other regulatory activities presently lodged in the banking agencies and the FHLBB could be reorganized along functional lines. For example, the SEC could be given exclusive jurisdiction over all securities matters relating to banks and thrifts (it presently exercises such jurisdiction over holding companies); the Justice Department could assume sole responsibility for antitrust enforcement; and the Federal Trade Commission could enforce compliance with consumer laws such as Truth-in-Lending.

The fact is that the current, fractionalized system of regulation and insurance for banks and thrifts is increasingly inefficient, ineffective and inequitable. Assuming it was justified when created 50 years ago, events have passed it by and it has outlived its usefulness. The system is in urgent need of a major overhaul.

CHAPTER VII

OPTIONAL EXCESS DEPOSIT INSURANCE

Page

Executive Summary VII-1

Introduction VII-1

Demand For Excess Coverage/Money Brokers VII-1

The FDIC as Suppliers of Excess Coverage VII-2

Semipublic Suppliers of Excess Coverage VII-3

Banks as Self-Insurers VII-4

Private Insurance Companies VII-4
    Capacity Contraints VII-5
    Inability to Assess and Control Risk VII-5
    Other Potential Barriers VII-7
    Diversification of Risk VII-7
    Safety and Liquidity Considerations VII-7
    Settling Depositor Claims VII-8

Alternatives for Private Sector Expansion VII-8

Public Demand and Government Involvement VII-9

CHAPTER VII

OPTIONAL EXCESS DEPOSIT INSURANCE

EXECUTIVE SUMMARY

Most private insurance companies surveyed by the FDIC have indicated no interest in expanding their limited role in providing deposit insurance in addition to the statutory federal protection. Industry representatives said they have not developed the means of evaluating risk in banks or controlling industry exposure in the insurance of deposits.

At present, there is no federal prohibition on provision of deposit insurance by private industry. Some private insurers currently provide protection for specific depositors or deposits on a limited basis. The FDIC investigation into the feasibility of a comprehensive program of privately provided excess deposit insurance indicates that the matter should be left to the dictates of market forces. The existing FDIC system is adequately funded and capable of providing higher levels of insurance protection to depositors, but such an effort in an era of deregulation of the financial-services industry may serve to penalize well-managed institutions and to insulate high risk takers from normal market judgment. Increased private sector participation had been viewed as a means of introducing a new element of discipline on bank risk taking, as private insurers would seek to minimize their potential losses by independently performing risk evaluation and imposing pricing judgments consistent with perceived exposure.

INTRODUCTION

This chapter discusses the feasibility of providing depositors the option to purchase Federal deposit insurance in excess of the current limit and also the capabilities of the private insurance system, either directly or through reinsurance, to provide that coverage. The merits of the FDIC providing excess deposit insurance coverage are discussed first. Alternative suppliers of excess coverage, including semipublic insurance programs, the banking system itself, and private insurance companies, are then examined. These potential suppliers of excess deposit insurance are measured against the standards of increased depositor protection and greater market discipline. The latter standard is an important element for a healthier and more stable banking environment.

DEMAND FOR EXCESS COVERAGE/MONEY BROKERS

A substantial volume of domestic deposits in commercial banks is held in accounts which are in excess of the federally-insured limit. In the aggregate there is an estimated $419 billion in domestic uninsured balances; suggesting an adequate market exists for optional excess coverage.[1] As shown in Table F1, the proportion of insured deposits is inversely related to bank size.

Despite a substantial proportion of uninsured deposits in many large banks, the demand for excess deposit coverage for this group has remained limited. Failures of large banks have generally been handled by a "purchase and assumption" transaction ("P&A") creating a market perception that funds deposited in larger banks are not at risk.

Changes in the economic and competitive environment, coupled with deregulation, may result in more risk for the banking industry and an increase in bank failures. In Chapter III there are discussed changes which would introduce large depositor risk-sharing. The potential exposure under this concept may also increase demand for excess coverage.

There exist, however, other means for reducing depositor risk. Recently, especially after the Penn Square Bank failure, there has been increased activity by brokers that specialize in dividing large certificates of deposits among numerous insured banks. This has the effect of providing full insurance coverage for large depositors. If perceived risk in the system increases, and remedial action is not taken, this practice will present an easy way to obtain excess coverage. The FDIC is considering a number of alternatives for correcting this problem, particularly the practice of some bankers of placing fully-insured funds in banks at random without credit analysis or, worse yet, placing them in known problem banks and collecting higher fees.

THE FDIC AS SUPPLIER OF EXCESS COVERAGE

There is no doubt that the FDIC has both the capacity and other resources to provide excess deposit insurance to either banks or individual depositors. As discussed in Chapter III, most bank failures have been handled in a manner that has provided de facto 100 percent coverage for both depositors and senior creditors. Normally, a failed bank will be paid off if a P&A is not possible or if this action is clearly the least costly alternative for the FDIC; thus, the capacity of the fund to withstand loss has not been a factor.[2]

Depending upon the pricing structure, there likely would be a demand for excess coverage provided by the FDIC. Depositors may want the coverage to reduce their perceived risk, whereas banks may want it as a substitute for pledging requirements, to gain access to more funding sources, to reduce effective costs of purchased money, or as a competitive weapon. Over the longer run, it is possible that competitive pressures would force most, if not all, banks to purchase excess coverage, resulting in explicit 100 percent deposit insurance.

1/ Refer to Appendix F for a more detailed discussion.

2/ Chapter V contains an analysis of the adequacy of the fund and alternative measures of exposure. The basic conclusion is that the fund is and probably will continue to be adequate to insure up to 100 percent of total deposits.

The overriding concern, and the theme of this study, is that the present structure of the Federal deposit insurance system has removed most incentives for depositors to choose banking relationships based on the assessment of risk. Until and unless the FDIC were able to price excess coverage to reflect individual bank risk, which seems a highly-remote possibility, discipline would be reduced.[3] Thus, the FDIC would strongly oppose any attempt to provide 100 percent Federal deposit insurance coverage.

SEMIPUBLIC SUPPLIERS OF EXCESS COVERAGE

Deposit insurance or guaranty schemes have been a part of our heritage since the 1820s. In this century, only the Federally-initiated systems and a few state-chartered funds can be deemed to have been successful. Semipublic insurers possess the ability to provide excess deposit protection. This sector may expand, but discipline can be imposed only if coverage is provided or withheld on the basis of risk; the two plans described below do not contain this important element.

Joint industry and state-initiated systems represent the most extensive form of private sector participation at this time.[4] Only a few of these programs, however, have attempted to offer complementary excess coverage in conjunction with the Federal systems. Characteristics for viable programs are examined in Appendix G. Discussed here are two which have many such characteristics and which offer complementary excess coverage in conjuction with the Federal systems. These illustrate approaches which have evolved embracing the umbrella concept.

1. The Mutual Savings Central Fund, Inc. ("Central Fund"): This state-initiated system comprises more than 150 mutual savings banks in Massachusetts. It provides full primary deposit coverage as well as a protection for deposit balances in excess of the FDIC insurance limits in some institutions. There are many similarities between this program and that of the FDIC as they both trace their origins to the early 1930s and have similar objectives.

   Several member institutions, numbering among the state's largest, have elected to join the FDIC. Under a unique joint arrangement, primary deposit insurance protection to a maximum of $100,000 per depositor is provided by the FDIC in such institutions, with all excess balances covered in full by the Central Fund's insurance program.

2. National Deposit Guaranty Corporation ("NDGC"): This organization was created by a special act of the Ohio State Legislature in 1973 for the purpose of protecting "share/deposit" balances in nonfederally-insured credit unions. The NDGC now operates in several states and

---

[3] Refer to Chapter II for a discussion of risk-related insurance.

[4] Refer to Appendix G for a review of these deposit insurance programs.

offers both a voluntary alternative to National Credit Union Share Insurance Fund ("NCUSIF") coverage and a complementary excess insurance protection for aggregate amounts over the NCUSIF insurance limits.

The NDGC employs a novel method of funding its insurance reserve. Essentially, a one-time refundable deposit of an amount equivalent to one percent of an institution's total "deposit" base is required for coverage by NDGC, assuming certain minimum standards of financial viability are met. Periodic accountings rendered by members are used, as a substitute for annual premium assessments, to maintain a reserve fund approximately one percent of NDGC's exposure level. While some may view this approach as a relatively costly means of obtaining protection, when contrasted with the Federal deposit insurance systems, a reserve fund can be quickly created and maintained to fund expansion and permit diversification.

BANKS AS SELF-INSURERS

The banking industry has demonstrated an ability and selective willingness to support individual institutions, thereby providing depositor protection. However, this support lacks the characteristics of an "insurance system." Even if banks could and would pool risks in some manner, the FDIC sees no way of avoiding a "domino effect," particularly in times of financial stress.

PRIVATE INSURANCE COMPANIES

Private sector deposit insurance coverage is offered by some casualty and surety companies on a limited basis. This coverage generally takes the form of a surety bond, essentially providing clients with a guarantee that their deposit in a specific institution will be recovered at a specific time. Such coverage is not prevalent and has been confined to selected insurance clients with deposits in relatively large insured commercial banks or insured subsidiaries of large banking organizations. This surety concept is highly selective and may not lend itself to widespread coverage of depository institutions.

It has been suggested by some industry representatives that private sector participation could be encouraged by utilizing or building upon the infrastructure provided by the FDIC or by some other form of indirect subsidy or reinsurance. However, if no independent evaluation of risk is performed to minimize exposure, no additional discipline upon bank risk will be forthcoming. One method utilized by insurance companies to control their risk, cancellation of existing coverage, may be destabilizing and favor larger banks over community-oriented institutions. Untimely or arbitrary cancellation of coverage, based upon nonrisk-related criteria, may have an even greater destabilizing effect.

Private sector insurance companies face a number of obstacles as they seek to enter or expand in the deposit insurance field on a broad scale. A limited capacity, the inability to assess and control risk so as to justify normal "risk-reward" standards, and other hurdles suggest their participation in providing excess deposit coverage will remain limited. Their role in providing a discipline on bank risk-taking will likewise be limited.

Capacity Constraints

Most domestic insurers and reinsurers are constrained by governing state statutes and so-called "Treasury limits" to a maximum single exposure of not more than ten percent of capital and surplus.[5] Under traditional approaches, which consider exposure levels on a "per facility" and "per event" basis, neither the primary nor reinsurance companies appear to possess a sufficient capital base to provide full excess deposit insurance coverage to many of the Nation's largest banking organizations.

In 1981 the aggregate capital and surplus of all domestic property and liability insurers was approximately $68 billion, providing a theoretical maximum exposure limit (per individual bank) of about $6.8 billion. Additional capacity afforded by domestic "reinsurance" organizations increases this maximum limit by no more than $0.7 billion. Self-imposed maximum exposure levels of individual companies, including consideration of a company's existing exposure in banking organizations (other insurance liability and investments) also serve as constraining factors. A more realistic maximum capacity estimate would appear to be in the range of $1 to $2 billion per financial institution.[6]

One of the largest insurance packages ever assembled in this country was to provide for the "atomic pool" to insure against losses relating to a nuclear accident. After approximately 30 years of effort, which included Federal sponsorship, the total capacity assembled now equals just over $750 million of which only 42 percent is supplied by domestic insurers and reinsurers. Thus, this $320 million package may represent a good approximation of the maximum available voluntary domestic capacity per facility, per insurable event.[7]

Such capacity limitations clearly preempt blanket coverage of excess deposits for a large number of banks. For example, the FDIC estimates that two relatively large New York City based commercial banks each hold more than $15 billion in uninsured domestic deposits, not to mention their foreign deposits and nondeposit liabilities. Numerous smaller institutions also have uninsured deposit levels which would appear to exceed the total (individual insurable unit) capacity of the domestic insurance industry.

Inability to Assess and Control Risk

The evaluation and control of risk are important elements in a deposit insurance system. In recent years, the amount and type of financial data available

---

5/ It should be noted that this discussion is limited to the "domestic" insurance and reinsurance market as most "foreign" insurers are either prohibited from or typically do not underwrite so-called "financial guarantees."

6/ Based upon the work of C. Arthur Williams, Jr. (February 1983).

7/ Based on data (as of January 1983) supplied by Mr. Walker S. Richardson, Senior Vice President, Liberty Mutual Insurance Company, Boston, Massachusetts.

regarding the banking industry have increased; however, comprehensive evaluation of bank risk requires an onsite review.[8] Bank examination data pertaining to bank management and individual bank customers is not publicly available and there is no parallel private sector source of such information.

Federal bank supervisory authorities have means of assessing and controlling risk in financial institutions which are unavailable to private firms. Thus, the private sector would be unable to exert any real power to effect changes or institute an effective system of variable premiums to reflect risk. Insurance industry representatives indicated there is a preference for utilization of a single, flat-rate premium with applicants either "accepted" or "rejected". Insurance companies can be expected to exercise discipline only by refusing to offer coverage or by cancellation of existing coverage.

Both of these methods can have a destabilizing impact on banks and the banking system. Also, in practice, they may tend to favor large banking organizations over smaller, community-oriented institutions. If the decision to insure or not to insure is based upon risk-related criteria and judgments as to an individual institution's viability, market discipline may be achieved. Rapid (or untimely) cancellation of existing coverage, however, could still have serious implications. Individual community banks could be additionally threatened if such cancellations impel local customers to move their deposits to regional or money center institutions. If coverage were cancelled at a relatively large bank, the consequences could be far ranging and much more severe than suggested by the event itself.

Refusal to write insurance coverage or cancellation based upon nonrisk criteria, while defensible on business or economic grounds, could result in even greater destabilizing consequences. In the insurance industry, it is not an uncommon practice simply to refuse to renew some lines of coverage for all customers or to cease to write coverage to entire groups (or categories of customers) based upon nonfinancial criteria such as product line or geographic location.

Representatives of the insurance industry have indicated that they must retain the flexibility to refuse coverage and to cancel the insurance relationship without specifying the reasons for such a decision. They have expressed concern that this issue could lead to regulation over their business judgments and fear that they may be "pressured" to write or renew coverage. Private sector insurers do not want to be regulated (as to entry to or exit from this line of coverage), nor do they wish to assume the role of "regulator" to control bank risk. Also, insurers voiced concern as to the potential legal responsibility for damage to a bank resulting from the cancellation of coverage.

---

[8] Chapter IV of this study contains a more detailed discussion of the issues relating to public disclosure of such data.

Maintenance of the public trust in the basic safety of funds and soundness of the banking system is vital. Abrupt withdrawal of coverage could lead to depositor flight prompting incidences of bank runs which were prevalent in the 1930s. If private sector participation in the deposit insurance field is to become widespread and beneficial, private insurers must have a "graceful withdrawal" mechanism.

Other Potential Barriers

By comparing and contrasting some of the earlier insurance and guaranty programs with the Federal systems and considering comments made by representatives of both the insurance industry and banking community, the FDIC has identified other potential barriers to a higher level of private sector participation.

Diversification of Risk — Banking is subject to uncertainties that are normally not regarded as commercially insurable. For example, the rate of bank failures can be related to fluctuations in the economic cycle which are, to a large extent, influenced by monetary and fiscal policies.

The ability to diversify risk among a large number of institutions in a variety of geographic locations and economic environments is an essential component of a stable insurance system. No one single event, economic setback or natural calamity should be able to impair the viability of insurance protection.

A relatively large market share is essential to achieving sufficient diversification rapidly. The required level of commitment, additionally aggravated by the difficulty of properly balancing the level of exposure and concentration of risk posed by multibillion dollar banking organizations, is another hurdle.

Safety and Liquidity Considerations -- All Federal deposit insurance plans explicitly limit investment of funds to United States Government obligations. The safety of the insurance fund and the ability to provide funds in an emergency must be assured.

As profit-motivated entities, insurance companies are more likely to seek higher-yielding investments which may be longer-term or riskier. Understandable as an appropriate business approach, this could result in a less-secure and less-liquid portfolio. In a serious financial emergency there could be a reluctance to liquidate these instruments . If the government does not advance the funds to cover the insurers' liability for an interim period, as suggested by industry representatives, public confidence could be eroded.

The ability of an insurer to sufficiently augment loss reserves through cash flow or borrowings is necessary. If premiums are raised beyond some reasonable level, stronger institutions would reject coverage, further reducing the cash flow from premium income. Moreover, alternate sources of funds, such as credit lines at commercial banks, could be inadequate or unavailable in times of severe economic difficulty for the banking industry at the very time they are needed.

Settling Depositor Claims -- While one of the goals of any effective deposit insurance program should be to minimize losses, bank failures will occur, and a set of practices and procedures for dealing effectively with this eventuality may be required. The Federal system has worked with little disruptive impact from a bank closing as it provides insured depositors with almost immediate access to their insured funds. The expectation of "minimum disruption" is a major stabilizing factor in the banking system. A private sector deposit insurer may be unable or unwilling to adhere to a costly practice of rapid claims settlement.

When bank failures occur, the liquidation effort and the payment of depositor claims are highly labor intensive, requiring large numbers of trained personnel for relatively short periods of time. Meeting these requirements could be cost prohibitive for an individual company. An industry-wide pooling effort, however, might succeed in establishing a workable and relatively efficient structure to handle such functions.

ALTERNATIVES FOR PRIVATE SECTOR EXPANSION

While there are obstacles to the widespread development of private sector deposit insurance programs, opportunities for expansion and experimentation are feasible by targeting market segments. The following approaches are presented as examples which would be modest in scope and would appear to offer some prospects for success.

1. Individual Bank Entities or Banking Organizations -- Coverage could be offered in a traditional form for all depositors of a bank (or group of affiliated banks) for a particular band of exposures greater than the Federal limits. This would establish a modest, but known exposure level which could be within capacity constraints.

2. Individual Business Enterprises -- Coverage could be marketed on a voluntary basis to only those corporations, businesses, trustees of funds, and individuals who typically maintain large (uninsured) balances in banks. Under this approach the insurer, or syndication, could structure a surety contract so as to limit the exposure only to selected third parties (banks or other financial intermediaries) which meet preset criteria as to financial strength.

3. Bank Entities for Allocation Among Deposit Customers -- Coverage of a maximum fixed-dollar aggregate could be marketed to individual banks or banking organizations whose management, in turn, would allocate this coverage among existing deposit customers and to attract new, relatively large depositors. This appears to be a quite flexible approach for all parties involved. It would (theoretically) lower total premium costs for the bank when compared with full umbrella coverage; it would allow individual depositors to choose whether or not to pay for additional protection; and it would establish maximum exposure levels for the contracting insurer.

The private sector can, and usually does, move to meet a need for services. The absence of widespread participation by non-Federal insurers indicates that either demand is modest or insufficient profit motive is present. Should demand increase, private sector deposit insurance products will likely develop on their own merit. The FDIC has established a dialogue with insurance industry representatives and remains willing to work with them to ease or remove obstacles.

PUBLIC DEMAND AND GOVERNMENT INVOLVEMENT

The question of what role, if any, the government should play in encouraging increased private sector participation or in the development of a new private sector insurance vehicle may be answered through several alternate courses of action which can be pursued. Each, however, requires a progressively higher level of government involvement.

The Federal deposit insurers could indirectly subsidize the private sector by providing basic intrastructure and logistical support -- data, risk evaluation and control, liquidity and liquidation -- on a permanent or temporary basis. A direct subsidy in the form of a "cap" or "stop loss" protection, reinsurance, or underwriting a private risk pool could also be supplied. These approaches, however, would increase the Federal insurance fund's own exposure level and could prove to be quite costly, without achieving a concomitant increase in discipline of bank risk-taking.

The questions as to equity and fairness also arise in any direct or indirect government assistance program which singles out a particular segment of the business community for subsidy or special treatment. If the existing Federal deposit insurance funds are used to support such a private sector endeavor, the net costs to the insured banking system (and ultimately, to the banking public) will increase. The result would, in effect, represent an involuntary transfer of capital from the banking industry to the insurance industry for the purpose of encouraging a more rapid development of a private sector product for which there may only be a limited demand.

APPENDIX A

LITERATURE ON RISK-RELATED INSURANCE SYSTEMS FOR COMMERCIAL BANKS

INTRODUCTION

The following is a review of the literature concerned directly with risk-related deposit insurance schemes for commercial banks. Since all of this literature deals either explicitly or implicitly with the advantages of such a system, we begin the review with an overall examination of the current system of fixed-rate assessments and compare it with the "ideal" risk-related system. This is followed by an examination of that portion of the literature which deals with risk measurement and the actual implementation of a risk-related deposit insurance system. The final section of this paper presents a discussion of issues yet to be resolved as well as our conclusions.

AN EXAMINATION OF FIXED AND RISK-RELATED DEPOSIT INSURANCE ASSESSMENTS

Current System

Because the current system of deposit insurance consists of fixed-rate assessments, it must be combined with a fairly extensive system of supervision and regulation in order to limit the exposure of the insurance fund. This supervision and regulation primarily involves the imposition of capital standards along with restrictions and enforcement procedures designed to maintain an acceptable level of bank asset quality. This system has been open to criticism on several fronts.

First, since all banks pay the same premium rate, healthy banks subsidize weak banks. It would be more equitable, it has been argued, if the FDIC charged each bank a premium which reflected the threat posed by the institution to the deposit insurance fund.

Second, extensive supervision and regulation limit the flexibility of bank management. In unregulated markets, managers can choose their desired trade-off between profitability and safety. For commercial and savings banks, this flexibility exists only within certain limits. This may be inefficient in the sense that banks may be restricted from certain activities which regulators feel are "too risky," even though the profitability of these activities may more than adequately compensate for the added risk. Moreover, some [21] argue that banks are required by regulators to maintain a greater than optimal level of capital. Others [17, 22] believe the level of capital is not excessive. If the amount of bank capital is too high, then an additional inefficiency occurs, since resources are shifted from more to less productive uses. The cost of this additional capital may exceed the combined benefit of the added capital to the institution and to society in general.

Finally, given the prevailing view that an optimal level of bank capital is difficult to determine, the standards imposed become somewhat arbitrary. That is, since bank risk is only roughly estimated, adequate levels of capital can only be approximated.

Risk-Related System -- In Theory

The ideal variable-rate insurance system would be designed so that insurance premiums would exactly reflect the expected cost of each institution to the insurance fund. Bank premium assessments would equal the probability of bank failure multiplied by the cost of failure to the insurance fund. Assuming for the moment that this ideal system could be developed, all of the previously mentioned shortcomings of the current system would be eliminated.

The system would be more equitable, since each bank would be charged a premium commensurate with the threat it posed to the insurance fund. Moreover, a risk-related system would also reduce the level of explicit regulation by replacing it with implicit price regulation. Many experts [6, 21, 22, 31] argue that deposit insurance substitutes for bank capital in maintaining depositor confidence in the banking system; therefore, the only significant role for bank capital is to protect the FDIC's risk exposure. If the FDIC can cover its exposure by basing premiums upon risk, conceivably capital standards would no longer be necessary.1/ Similarly, restrictions on certain types of assets deemed excessively risky could be eliminated, since premium differentials could also compensate the FDIC for this type of risk exposure. Management at each bank could then decide whether or not to enter new product markets by weighing potential profits against the costs (including the mandated insurance premium) tied to such product expansion. Of course, at some point risks could become so great that the costs of providing insurance make them virtually uninsurable. Also the costs of measuring each risk (i.e., onsite examination and offsite monitoring) could well be prohibitive.

The replacement of explicit regulation with risk-related premiums would result in a more efficient allocation of bank resources. An optimal degree of risk-taking would result as bank managers would be able to adjust their risk-exposure according to their own judgment. Bankers could engage in heretofore prohibited activities as long as they are willing to pay to the insurance fund the expected cost of this risk. In this sense resources would be allocated

---

1/ This would be true if bank failures were not disruptive to the economy. Under a system of partial insurance coverage, failures (particularly if large banks were involved) may be disruptive. However, this problem could be solved by the imposition of 100 percent deposit coverage. The loss of "market discipline" from such action would not be important since the risk of banks would be monitored by the proper pricing of insurance.

more efficiently yet, at the same time, the insurance fund would not be threatened (since it is assumed that the expected cost to the fund from each banking activity can be correctly measured and priced).

Furthermore, the arbitrary nature and the enforcement problems of the present system would no longer exist. For example, under the current system many banks are urged to increase their capital; however, the figures aimed at are, to a certain extent, arbitrary and compliance is not uniform. Under a variable-rate system with precisely determined risk measurements, subjective capital standards would be replaced with objective evaluations of the costs associated with various levels of capital. Moreover, compliance would not be an issue since regulations designed to minimize risk would be replaced by mandatory variable-rate premium assessments.

It is clear that a properly implemented risk-related insurance system (that is, one in which assessments closely approximate the expected cost of each bank to the deposit insurance fund) would be superior to our current system. However, risk-related systems have been criticized because of the difficulty of properly measuring risk (for example, the Hunt Commission Report [24]), and it is conceded that precise measurement is near impossible even if the insurer were to have the unlimited personnel and technological resources to perform the function. Thus, some regulatory constraints with respect to capital levels and banking activities will likely be required irrespective of how any risk-related insurance system is designed. The following section includes an examination of the literature regarding risk measurement and the implementation of a risk-related system.

LITERATURE REVIEW -- IMPLEMENTATION OF A RISK-RELATED DEPOSIT INSURANCE SCHEME

Although many have recommended that the FDIC adopt a risk-related insurance scheme, the literature contains very little regarding the actual implementation of such a system. As yet, no one has developed an adequate means to measure risk so that variable-rate deposit insurance could be meaningfully applied to all commercial banking institutions. Much of the discussion in the literature has been limited to mere suggestions and, therefore, does not contain details of how such a system would be actually implemented. Merton [19] has shown that option pricing theory can be applied to determine the value of deposit insurance. When someone purchases a put option they have bought the right to sell a specific number of securities at a specific price to the writer of the contract. The buyer of the put option has purchased the right to transfer assets owned (the securities) to the writer of the contract; hence, the writer is insuring the buyer from a price decline. (The buyer would not sell the stock to the writer if prices go up since the buyer can make more in the market.) Some insurance contracts resemble put options in the sense that purchasers buy the right to transfer their liabilities to the insurance company upon the occurrence of certain events. Just as the writer of the put option receives a fee for accepting the risk of receiving a lower value in the event security prices decline, an insurance company accepts premiums for assuming the risk of the insured. In a sense, the value of a deposit insurance contract can be viewed in the same light as that of a put option; therefore, the pricing formula for put options can be used to price deposit insurance contracts.

McCulloch [18] used an option pricing model to estimate the value of deposit insurance to banks. The shortcoming of this study is that only interest-rate risk was considered. Based upon recent experience, interest-rate risk has played a major part in only a few bank failures.

Marcus and Shaked [15] employed option pricing theory to obtain estimates for the value of deposit insurance for 40 relatively large commercial banks (accounting for 50.5 percent of total commercial bank deposits) for both 1979 and 1980. Their particular methodology, however, requires the use of time series data on the stock prices of individual banks. Unfortunately, only a handful of bank stocks are traded in markets which are considered competitive. Therefore, this technique cannot be applied to the majority of banks. In addition, this method implicitly assumes that bank risk is measured by the market and is thus reflected in stock prices. The degree to which this process actually takes place is not clear.

Maisel [13] suggests that five types of risk be estimated to determine overall bank risk. These risks include: (1) interest-rate risk -- sensitivity of earnings to interest rate movements, (2) credit risk -- risk that assets will go into default or perform poorly, (3) moral hazard risk -- risk due to fraud or insider abuse, (4) operating risk -- risk that operating margins will deteriorate, and (5) diversification risk -- risk due to failure to diversify. From his analysis Maisel concludes that exact risk measurement is not possible. However, he states that certain risks (*e.g.*, interest-rate risk) are quantifiable and that empirical estimates of risk can show orders of magnitude, which is all that would be necessary in order to implement a risk-related premium structure.

Scott and Mayer [27] suggest that bank failure prediction models may yield useful information relative to insurance assessment. These models use selected financial ratios in an effort to predict which banks are more prone to failure. If these models can accurately predict bank failure with sufficient lead time, the ratios used within the models may then serve as a basis for assessing risk. (A separate evaluation of this literature is provided below.) On a somewhat less ambitious scale, both Scott and Mayer, and Peltzman [22] have suggested the use of bank examination ratings as a basis for determining the risk of an institution. Examiners do use a uniform rating system (known as CAMEL) to grade the quality of capital, assets, management, earnings, and liquidity and to assign a "composite" or overall score ranging from 1 to 5. This could be used as a basis for assigning different insurance premiums but such a system would have several drawbacks.

First, a CAMEL-based system may be relatively expensive to properly implement. To the extent that it is desirable to assess the risk of banks on a yearly basis, every bank would have to be examined annually. This is more frequent than is currently the case for the majority of banks and, therefore, would be more expensive than a system based solely on Call data. Additionally, this would conflict with current FDIC policy which is directed toward increasing the time between bank examinations. Second, the CAMEL rating system is somewhat subjective in that: (1) the ratings are based, to a large extent, on examiner judgment; and (2) banks are examined by different agencies, each of which does not necessarily view risk in the same light. Finally, the linkage of the CAMEL rating to the insurance assessment may create an adversarial rela- tionship between bank examiners and management. The examiner/management rela- tionship is important in determining CAMEL ratings, therefore, damage to this relationship may reduce the reliability of the ratings.

Peltzman also suggests that the cost of uninsured deposits may form the basis for assessing premiums. The notion being that riskier banks are forced to pay a higher rate for their uninsured deposits, thus, the market has provided a mechanism whereby risk can be measured. However, not all banks operate in markets competitive enough that their large certificate of deposit rates would provide useful information. Moreover, some banks may pay more for their deposits due to regional or other factors not related to their risk. Finally, it is not clear what deposits are perceived by the market as being uninsured. If the market feels that the FDIC will not pay off a large institution, then all of the deposits of these banks will be viewed as insured. Thus, risk premiums for large banks may underestimate actual bank risk.

CONCLUSION AND DISCUSSION

As a whole, the literature on risk-related deposit insurance systems strongly suggests that, depending upon the type of variable-rate insurance system that might eventually be implemented, it would be no worse than our current system and would, in all likelihood, improve the system in several ways. However, the literature provides little guidance with regard to the implementation of a system which would be applicable to all commercial banks. Although various approaches have been suggested, they all have serious drawbacks. It appears that despite its desirability, much additional empirical work must be completed before a comprehensive and reliable risk-related insurance system can be implemented.

Consequences of Improperly Measured Risk

Moreover, even with additional work, it is likely that bank risk can only be roughly estimated. This creates several problems which would not exist under the "ideal" variable-rate system. Variable insurance premiums are designed to create incentives to alter bank behavior. Improperly priced premiums may elicit behavior which is unintended and in some ways may even be perverse. For example, if premium differentials are too high, the FDIC will be overcompensated for incremental risk-taking, which will encourage bank managers to be overly conservative. If premium differentials are too low, excessive risk-taking will occur. Either way, since the bank's cost from a given activity will not reflect the true cost of any incremental risk-taking, an optimal allocation of resources will not result.

Furthermore, since risk measurement is not exact, capital adequacy standards and restrictions against owning particular types of assets will, to a certain extent, remain in effect. That is, if premium differentials are too low, the situation will be similar to the current flat-rate assessment system in that the FDIC and other regulatory agencies will deem it necessary to impose certain controls to limit excessive risk-taking. If premium differentials are too high, implicit restrictions will be imposed since bank managers will not choose to maintain low levels of capital or to participate in certain markets due to the excessive penalties that would be incurred.

Finally, any system based upon approximate measures of risk will be less equitable than the "ideal" variable-rate plan. Imprecisely measured premium differentials either overcharge or undercharge banks for incremental levels of risk-taking. Moreover, to the extent that the number of risk categories is limited and banks with different levels of overall riskiness are grouped together and charged the same premium rate, a further inequity exists.

Comparison of Imprecise Risk-Related System to the Current System

Nevertheless, even though a variable-rate insurance system based upon imprecisely determined risk measurements may be less than ideal, it would still have several advantages over the current system. First, some regulation could be eliminated. The extent to which deregulation can occur depends upon the degree to which bank risk can be measured.

Second, if this regulation is reduced, bank management should have greater flexibility in choosing the desired tradeoff between profits and safety. This should lead to an improved allocation of resources. Where the riskiness of a particular activity is uncertain, premium differentials may tend to overcompensate for the risk involved. However, even if the premiums appear excessive, banks would at least be given a choice. Some bankers may feel they have enough of a competitive edge to make participation in certain new markets worthwhile. The degree to which premium differentials are accurately priced will determine the extent to which management flexibility will be enhanced and resource allocation improved.

Third, a risk-related system has the potential to be more equitable. The greater the number of risk categories into which banks can correctly be classified, the more equitable the system will be.

A final advantage of a risk-related system is that enforcement will be more uniform. While there may be some variation in regulation and supervision designed to curb excessive risk-taking, each insured institution would have to pay the mandated premium assessment rate.

Bibliography

1. Barnett, Robert E.; Horvitz, Paul M.; and Silverberg, Stanley C. "Deposit Insurance: The Present System and Some Alternatives." Banking Law Journal 94 (April 1977): 304-332.

2. Buser, Stephen A.; Chen, Andrew H.; and Kane, Edward J. "Federal Deposit Insurance, Regulatory Policy, and Optimal Bank Capital." Journal of Finance 36 (March 1981): 51-60.

3. Edwards, Franklin R., and Scott, J. "Regulating the Solvency of Depository Institutions: A Perspective for Deregulation." In Issues in Financial Regulation, pp. 65-105. Edited by Franklin R. Edwards. New York: McGraw-Hill, 1979.

4. Federal Deposit Insurance Corporation, Division of Research, "Study of Federal Deposit Insurance," Washington, D.C. (Mimeographed.)

5. Friedman, Benjamin M., and Formuzis, Peter. "Bank Capital: The Deposit-Protection Incentive." Journal of Bank Research 6 (Autumn 1975): 208-218.

6. Gibson, William E. "Deposit Insurance in the United States: Evaluation and Reform." Journal of Financial and Quantitative Analysis 7 (March 1972): 1575-94.

7. Golembe Associates Inc. "Deposit Insurance Reform: Part Two." Golembe Reports, Volume 4, 1977.

8. Jacobson, Robert. "Forecasting Bank Portfolios." In Risk and Capital Adequacy in Commercial Banks, pp. 249-70. Edited by Sherman J. Maisel. Chicago and London: The University of Chicago Press, 1981.

9. Kareken, John H. "Deregulating Commercial Banks: The Watchword Should be Caution." Quarterly Review, Federal Reserve Bank of Minneapolis 5 (Spring/Summer 1981): 1-5.

10. Kareken, John H., and Wallace, Neil. "Deposit Insurance and Bank Regulation: A Partial Equilibrium Exposition." Journal of Business 51 (July 1978): 413-438.

11. Kreps, Clifton H., Jr., and Wacht, Richard F. "A More Constructive Role for Deposit Insurance." Journal of Finance 26 (May 1971): 605-614.

12. Lane, David., and Golen, Lawrence. "Some Simulation-Based Estimates of Commercial Bank Deposit Insurance Premiums." In Risk and Capital Adequacy in Commercial Banks, pp. 341-65. Edited by Sherman J. Maisel. Chicago and London: The University of Chicago Press, 1981.

13. Maisel, Sherman J. Risk and Capital Adequacy in Commercial Banks. Chicago and London: The University of Chicago Press, 1981.

14. Maisel, Sherman J., and Jacobson, Robert. "Interest Rate Changes and Commercial Bank Revenues and Costs," Journal of Financial and Quantitative Analysis 13 (November 1978): 687-700.

15. Marcus, Alan J., and Shaked, Israel. "The Valuation of FDIC Deposit Insurance: Empirical Estimates Using the Options Pricing Framework." Boston University School of Management, May 1982. (Mimeographed.)

16. Mayer, Thomas. "A Graduated Deposit Insurance Plan." Review of Economics and Statistics 47 (February 1965): 114-116.

17. Mayne, Lucille. "Supervisory Influence on Bank Capital." Journal of Finance 27 (June 1972): 637-651.

18. McCulloch, J. Huston. "Interest Rate Risk and Capital Adequacy for Traditional Banks and Financial Intermediaries." In Risk and Capital Adequacy in Commercial Banks, pp. 223-48. Edited by Sherman J. Maisel. Chicago and London: The University of Chicago Press, 1981.

19. Merton, Robert C. "An Analytic Derivation of the Cost of Deposit Insurance and Loan Guarantees: An Application of Modern Option Pricing Theory." Journal of Banking and Finance 1 (June 1977): 3-11.

20. ________. "On the Cost of Deposit Insurance When There Are Surveillance Costs." Journal of Business 51 (July 1978): 439-452.

21. Mingo, John J. "Regulatory Influence on Bank Capital Investment." Journal of Finance 30 (September 1975): 1111-21.

22. Peltzman, Sam. "Capital Investment in Commercial Banking and its Relationship to Portfolio Regulation." Journal of Political Economy 78 (January/February 1970): 1-26.

23. ________. "The Costs of Competition: An Appraisal of the Hunt Commission Report." 4 (November 1972): 1001-4.

24. Report of the President's Commission on Financial Structure and Regulation. By Reed O. Hunt, Chairman. Washington, D.C.: Government Printing Office, December 1971.

25. Rosenberg, Barr, and Perry, Philip R. "The Fundamental Determinants of Risk in Banking." In Risk and Capital Adequacy in Commercial Banks, pp. 367-407. Edited by Sherman J. Maisel. Chicago and London: The University of Chicago Press, 1981.

26. Santomero, Anthony M., and Watson, Ronald D. "Determining the Optimal Capital Standards for the Banking Industry." Journal of Finance 32 (September 1977): 1267-1282.

27. Scott, Kenneth E., and Mayer, Thomas. "Risk and Regulation in Banking: Some Proposals for Federal Deposit Insurance Reform." Stanford Law Review 23 (May 1971): 537-582.

28. Sharpe, William F. "Bank Capital Adequacy, Deposit Insurance and Security Values." Journal of Financial and Quantitative Analysis 13 (November 1978): 701-718.

29. Wolkowitz, Benjamin. "Bank Capital: The Regulator Versus the Market." In The Deregulation of the Banking and Securities Industries, pp. 243-261. Edited by L.G. Goldberg and L.J. White. New York: Lexington Books, 1979.

30. ________. "Measuring Bank Soundness." Proceedings of a Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, Chicago, Illinois, 1975.

31. ________. "The Desirability of Establishing Risk-Related Premiums for FDIC Insurance." Working Paper, Federal Reserve Board of Governors, Washington, D. C., 1975.

APPENDIX B

LITERATURE ON FAILURE PREDICTION MODELS FOR COMMERCIAL BANKS

INTRODUCTION

The feasibility of risk-related insurance assessments depends on the extent to which bank risk can actually be measured. Implementation of an equitable and justifiable variable-rate premium structure does not require exact measurements of risk but there should be some empirical or actuarial support for whatever system is employed to assign banks to particular risk classes. In order to shed light on the issues involved in measuring risk, this appendix examines the literature dealing with bank failure and problem bank prediction models. It should be noted at the outset that only commercial banks are referred to in this literature review. The analysis is not directly applicable to mutual savings banks since the characteristics of these two types of institutions differ.

These models attempt to differentiate between healthy and either failing or problem institutions on the basis of selected financial ratios. While the models have been developed primarily as a means to help bank regulatory agencies allocate examination resources more efficiently, they can provide useful information regarding the feasibility of a variable-rate insurance system. If bank failures can be predicted with a reasonable amount of lead time and accuracy, it should be possible to develop a system that relates premiums to failure risk. Failure and problem bank prediction models also yield useful information regarding which financial ratios are important in distinguishing healthy from failing banks.

SURVEY OF THE LITERATURE

A brief review of the problem bank prediction literature is provided below. Although it is not all inclusive, it provides a representative sample of the literature. The survey is divided into two subsections: one dealing with failure prediction models and the other covering problem bank prediction models.

Failure Prediction Models

This section includes a discussion of four studies in which failure prediction models have been constructed. The approach taken in these studies is basically the same; a group of actual bank failures is identified and various financial characteristics of these banks, one or more years prior to failure, are compared with financial characteristics from a group of banks that did not fail. Generally, each failed bank is paired with a solvent bank with similar nonfinancial attributes such as size, age and location. In a limited sense, this method allows the researcher to control for factors that otherwise might distort the relationship between financial characteristics and failure. To the extent that these controlled attributes are important factors contributing to bank failure, the predictive ability of the model will be diminished.

The studies use various types of statistical techniques such as discriminant and logit regression analyses to distinguish the financial characteristics of failing from solvent banks. These statistical approaches are similar in the sense that they allow the researchers to test the importance of many financial ratios in a bank failure model simultaneously. The ratios are computed from bank income, Call and/or examination reports and were selected on the basis of their ability to explain bank failure. That is, the researchers used various combinations of financial ratios and ultimately selected the combination that yielded the best predictive results.

The statistical analysis produces an equation (or equations) which measures the likelihood of failure. As a test of the predictive capability of the model, the original sample of failed and nonfailed banks is reclassified, i.e., the financial ratios of each bank are "plugged" into the equation(s) of the model and each bank is classified as either a likely or nonlikely candidate for ultimate failure. Often a holdout sample (banks not in the original sample) is tested to help assess the model's predictive accuracy.

However, the model with the best overall classification accuracy is not necessarily the "best" model. It is important to distinguish between what statisticians call Type-I error (classifying a true failure as a nonfailing institution) and Type-II error (when nonfailures are classified as failures). In any model there is a tradeoff between the severity of each of these types of errors. Increasing the level of Type-I error means that the model will incorrectly classify more failures, whereas an increased Type-II error means that more nonfailures will be classified as failures. The importance of the different types of errors depends, to a large extent, upon the purpose for which the model will be used.

As mentioned previously, the failure prediction models developed to date were created to aid in the examination process. Thus, there was a desire to minimize Type-I error, since the inability to recognize a failing institution could become a costly mistake. On the other hand, a model developed in connection with a risk-related insurance scheme should be designed to minimize Type-II error. This would reduce the number of situations where banks would be charged an insurance premium intended for riskier institutions.

Meyer and Pifer Study -- This study [8] was completed in 1970 and was the first bank failure study to use modern statistical techniques. Their total sample consisted of 78 insured commercial banks, 39 of which were closed between 1948 and 1965. Failed banks were paired with solvent banks by size, age, location, and the primary regulatory agent. Data for paired banks were collected from bank income, Call and examination reports, for each of the six years prior to the failed bank's closing. Closed banks with incomplete records and supervisory mergers of failing institutions were not included in the sample.

Meyer and Pifer conclude that even though many bank failures result from embezzlement and other financial irregularities, financial measures can, with a lead time of one or two years, accurately predict bank failures (80 percent success rate). However, when the lead time is greater than two years, financial variables are ineffective predictors. The financial ratios in their most effective prediction models include variables such as the ratio of operating revenue to operating costs and the growth in extensions of credit to directors, officers, employees and affiliates relative to total capital.

Sinkey Study -- This study [17] applied discriminant analysis classification procedures to derive single and multivariate failure prediction models for up to six years prior to bank failure. The 37 insured commercial banks that failed between 1970 and 1975 were paired with 37 nonfailed banks on the basis of deposit size, number of branches, and location. A holdout sample consisting of the 16 banks that failed in 1976 was used to test the accuracy of the multiple variable models.

The total operating expenses to total operating income ratio was Sinkey's best single discriminator, showing 75 percent accuracy in classifying the original sample one year prior to failure. Overall accuracy gradually declined to 65 percent six years prior to failure. The Type-I error was relatively high, ranging from 25 to 60 percent (40 percent one year prior to failure). The Type-II error ranged from nine to 35 percent. Upon further analysis, Sinkey concluded that the significantly lower profitability experi- enced by failed banks during the six years prior to failure was due to rela- tively high operating expenses rather than lower operating income.

As one would expect, the results improved when additional variables were included in the failure prediction models. The best multivariate model for the two years preceding failure included the same operating efficiency variable (total operating expenses/total operating income) as well as a measure of bank safety (investments/assets). Overall accuracy in classifying the original sample one and two years prior to failure increased to 82 and 75 percent respectively. The respective Type-I errors were much better, 18.18 and 11.54 percent. The overall accuracy rose to 93.75 and 87.5 percent when the holdout sample was tested. The prediction models three to six years prior to failure did not perform as well, achieving only slightly better than 50 percent accuracy in classifying the holdout sample (despite an 80 percent success rate in classifying the original sample).

Martin Study -- Martin [7] applied logit and multiple discriminant analysis to develop failure prediction models for the six-year period between 1970 and 1976. His sample included the entire population of banks (on average, about 5,600) which were members of the Federal Reserve System. Fifty-eight banks were included in the failed bank category (defined to include all banks which closed, were involved in a supervisory merger or for which other emergency measures were used to resolve imminent failures). For testing purposes, a set of 25 financial ratios was chosen, representing asset risk, liquidity, capital adequacy and earnings.

Martin's most effective failure prediction model included four variables: net income/total assets, gross chargeoffs/net operating income, commercial loans/total loans, and gross capital/risk assets. Classification accuracy based upon data one to two years prior to failure was quite high for the 1973 to 1976 time period. For example, using 1974 data, Martin's logit model correctly classified 91.3 percent of the failures and 91.1 percent of the nonfailures which occurred in 1975 and 1976. However, as Martin correctly points out, this still implies that a relatively large number of nonfailures will be classified as failures.

The model is less accurate for the 1970 through 1972 period. However, reliable estimates for each of these years may be difficult to obtain due to the relatively small number of bank failures (12 in 1970, 12 in 1971, and 10 in 1972).

Rose and Scott Study -- The results of these first three studies seem to indicate that reasonably effective failure prediction models can be developed, but only with a lead time of one to two years. Rose and Scott [11] attempted to develop effective models for the 1970 to 1976 period with a lead time of up to nine years. Using multiple discriminant analysis they tested 110 financial ratios representing measures of profitability, liquidity, asset composition, capital structure, prices and expenses. Their best models achieved an overall classification accuracy of 75 percent for each of the two years prior to failure, however, accuracy rates declined to an average of 60 percent when data three to nine years prior to failure were used. Their most consistently important prediction variables were loans/total assets, net income/total capital, employee fringe benefits/total expenses and municipal securities/total assets. Each year the loan/asset ratio was the most important discriminating variable.

Alternative Approaches

Rather than dealing with failed banks, a number of researchers [14, 15, 16, 17, 19] have attempted to model a bank regulatory agency's list of "problem" banks. They cite two advantages to such an approach. First, problems associated with an inadequate sample size are avoided, since there are more problem banks than failed banks; and second, if a bank is classified as a problem bank prior to its actual failure, a model to predict such classifications may provide a longer lead time for corrective action.

However, from the standpoint of providing information for a risk-related insurance scheme, studying problem bank classifications may provide a smaller amount of information. Since many banks on the problem list do not fail and some banks fail without ever making the problem list, it cannot be assumed that the problem list accurately captures high risk situations. Therefore, a model which successfully identifies problem banks may be less accurate in pinpointing risky institutions.

This does not, however, imply that such models are without use. It can be easily argued that, even though some high risk institutions are not classified as problem banks, on balance banks which are on the problem list are riskier institutions. Therefore, problem bank prediction models should yield useful information as to the financial ratios which are important in identifying risky institutions.

It is, however, more difficult to test the accuracy of a problem bank prediction model. In the case of failure prediction, the event (failure) which one attempts to model is easier to identify. With problem bank prediction models, one's ability to identify a problem institution is clearly limited by the reliability of the problem bank list.

Sinkey [16] has shown that the most effective variable in distinguishing problem from nonproblem institutions is the examiner determined net capital ratio (capital minus adversely classified assets divided by total assets minus estimated losses). An early warning system based solely upon the net capital ratio (NCR) was 95.4 percent accurate in classifying the original sample of 306 problem and nonproblem banks (Type-I error was 4.9 percent). However, these results merely prove an identity since examiners classify banks as problem institutions if their NCR is too low. It does not prove the NCR is effective in distinguishing between failed and solvent banks.

Problem bank prediction models based upon balance sheet and income statement characteristics have not been very successful, since there seems to be a large overlap between problem and nonproblem bank financial characteristics. As a result, some researchers [15, 18] have chosen to work with what is referred to as outlier analysis. Outlier tests generally start by dividing banks into different peer groups and then seek to locate atypical banks, those with financial characteristics well beyond peer group averages. However, this approach has several drawbacks. First, the implicit assumption that peer group averages are the desired outcomes makes it impossible to determine the vulnerability of particular peer groups or the banking system as a whole. Second, the decision on the allowable deviation from the peer group average is entirely a subjective process. Third, there has been little effort to determine to what extent outliers include banks that eventually fail or present abnormal risks. Finally, while other techniques are designed to determine financial variables which are indicative of bank risk, it is not clear which financial variables should be considered during the outlier evaluation process.

In a further attempt to avoid the problems associated with problem bank and outlier analysis, other researchers [4, 5, 6, 20] have attempted to develop models that distinguish banks "vulnerable" to failure from banks "resistant" to failure. However, it is not clear how "vulnerable" should be defined. Korobow and Stuhr [4] derive a composite ranking of banks by weighing various financial variables they believe, on a theoretical basis, to be indicative of financial strength or weakness. Banks above an arbitrary cutoff point are considered resistant to failure while banks below the cutoff point are deemed vulnerable to failure. However, there is very little empirical evidence that these various definitions of bank vulnerability are closely related to the incidence of actual bank failure.

Some of the more recent studies [9, 10, 13] have been attempts to develop early warning systems which incorporate bank stock prices as an explanatory variable. According to the efficient market hypothesis, stock prices represent a firm's intrinsic value and any new information regarding that firm's condition will be quickly and accurately reflected in the price of its common stock. If this is true, and these studies suggest that it is, bank stock prices should be included with accounting and examination data in developing an early warning system. However, only a small percentage of banks have publicly traded stock. Therefore, at best this market information is useful in only a limited number of situations and could not provide much input for a variable rate deposit insurance system.

DISCUSSION OF CURRENT LITERATURE

In some instances, failure prediction models have, with a one- or two-year lead time, achieved over 90 percent accuracy in distinguishing between solvent and failing institutions. However, the usefulness of a particular prediction model in a risk-related insurance scheme depends largely upon its ability to minimize the Type-II error, since the overwhelming majority of banks would be more susceptible to this error rather than Type-I error. Studies to date have not emphasized minimizing Type-II error.

While prediction models may be fairly accurate in classifying banks from the sample and the time period from which they were developed, they may be far less accurate in predicting future bank failures since some ratios may be more reflective of risk at one point in time than another. However, few attempts have been made to see how well these models hold up over time.

The selection method for the various financial ratios has been based upon finding the combination that provides the best predictive capabilities for the sample period in question. Such a selection process provides little assurance that the model will predict with an equal degree of accuracy for a time horizon outside the sample period. A model based upon financial ratios selected because they should, in theory, affect bank failure, may prove over time to be a better predictor than a model where the ratios are selected in a more random fashion.

Moreover, there is no guarantee that the approach taken in these studies will produce a list of variables which is useful to a risk-related insurance system. For example, Rose and Scott found a negative relationship between the employee fringe benefits/total expenses ratio and the likelihood of failure. They suggest that a low ratio may be indicative of poor quality management and a relatively high risk of employee embezzlement or fraud. However, if this ratio were used to help determine insurance assessments, many banks may be unfairly penalized since relatively low levels of fringe benefits may be offset by relatively high wages and salaries. Moreover, the inclusion of this ratio in a risk-related insurance scheme may create an incentive for bank management to raise fringe benefits at the expense of wages and salaries.

In attempting to construct a failure prediction model, one should determine the types of risks or problems inherent in commercial banking that contribute to bank failure, select financial ratios that can serve as proxies for each of these and then test the overall effectiveness of the model. These risks or problems include the following:

1. Credit risk -- The risk that loans or other assets will default or perform poorly. Historically, a large percentage of banks have failed because of excessive losses resulting from poor quality assets.

2. Interest rate risk -- Bank earnings are sensitive to interest rate changes whenever the maturity structures of assets and liabilities are mismatched. In recent years, as interest rates have become more volatile, institutions with excessive asset/liability maturity mismatches have failed in greater numbers.

3. Moral hazard risk -- Many banks have failed because of fraud, embezzlement or insider abuse.

4. Diversification risk -- Concentrations of assets and liabilities in specific product lines, industries, locations or with related groups of individuals or companies subject banks to a greater risk of failure. To a certain extent, diversification risk is interrelated with credit and liquidity risk. Asset concentrations increase credit risk while liability concentrations increase liquidity risk.

5. Liquidity risk -- Sudden demands for cash withdrawals may lead to insolvency if the bank has insufficient liquid assets to meet those demands.

6. Operational inefficiency -- While inefficiency may not itself cause a bank to fail, banks with abnormally high noninterest costs are more susceptible to failure in the event that other problems arise.

In addition to the consideration of ratios which may measure these types of risk, one should also account for the importance of bank capital. Banks with high levels of capital are better able to withstand a given level of losses than are banks with low levels of capital. Thus, it seems appropriate that capital adequacy should also be a factor in determining a bank's probability of failure.

In the past, the development of effective failure prediction models has been impeded by the relative lack of commercial bank failures. Between 1943 and 1977, only 193 banks failed, about 5.5 per year. However, between 1978 and 1982 69 insured commercial banks failed, a rate of about 14 per year. Research incorporating these data from the past few years should add considerably to our knowledge in predicting bank failure.

One remaining data limitation deals with the identification of small versus large bank failures. Since relatively few large banks fail (banks over $1 billion), the data used to construct failure prediction models are drawn mainly from the smaller institutions. To the extent that it is "normal" for larger institutions to have different financial ratios, models developed on the basis of small bank data may not be applicable to the larger banks.

To summarize, it appears that much additional work needs to be done before bank failure prediction models may be used as a basis for a risk-related insurance scheme. As noted, all of the failure prediction models developed to date were developed for the purpose of assisting in the allocation of examination resources. This motive, however, has resulted in the development of models which have only limited application to insurance assessment problems. Failure prediction research used to assist the development of risk-related insurance assessments must be more sensitive to the informational needs of such a system.

Bibliography

1. Altman, Edward I.; Avery, Robert B.; Eisenbeis, Robert A.; and Sinkey, Joseph F., Jr. Application of Classification Techniques in Business, Banking and Finance. Contemporary Studies in Economic and Financial Analysis, Volume 3. Greenwich, Connecticut: Jai Press Inc., 1981.

2. Altman, Edward I., and Sametz, Arnold W. Financial Crises: Institutions and Markets in a Fragile Environment. New York: John Wiley & Sons, Inc. 1977.

3. Eisenbeis, Robert A. "Financial Early Warning Systems: Status and Future Directions." Issues in Bank Regulation 1 (Summer 1977) 8-12.

4. Korobow, Leon, and Stuhr, Davis P. "Toward Early Warning of Changes in Banks' Financial Condition: A Progress Report." Monthly Review, Federal Reserve Bank of New York 57 (July 1975) 157-165.

5. Korobow, Leon; Stuhr, Davis P.; and Martin, Daniel. "A Nationwide Test of Early Warning Research in Banking." Quarterly Review, Federal Reserve Bank of New York 2 (Autumn 1977) 37-52.

6. ________. "A Probabilistic Approach to Early Warning of Changes in Bank Financial Condition." Monthly Review, Federal Reserve Bank of New York 58 (July 1976) 187-94.

7. Martin, Daniel. "Early Warning of Bank Failure: A Logit Regression Approach." Journal of Banking and Finance 1 (November 1977) 249-76.

8. Meyer, Paul A., and Pifer, Howard W. "Prediction of Bank Failures." Journal of Finance 25 (September 1970) 853-868.

9. Pettway, Richard H. "Potential Insolvency, Market Efficiency, and Bank Regulation of Large Commercial Banks." Journal of Finance and Quantitative Analysis 15 (March 1980) 219-36.

10. Pettway, Richard H., and Sinkey, Joseph F., Jr. "Establishing OnSite Bank Examination Priorities: An Early-Warning System Using Accounting and Market Information." Journal of Finance 35 (March 1980) 137-50.

11. Rose, Peter S., and Scott, William L. "Risk in Commercial Banking: Evidence from Postwar Failures." Southern Economic Journal 45 (July 1978) 90-106.

12. Santomero, Anthony M., and Vinso, Joseph D. "Estimating the Probability of Failure for Commercial Banks and the Banking System." Journal of Banking and Finance 1 (October 1977) 185-205.

13. Shick, Richard A., and Sherman, Lawrence F. "Bank Stock Prices as an Early Warning System for Changes in Condition." Journal of Bank Research 11 (Autumn 1980) 136-46.

14. Sinkey, Joseph F., Jr. "A Multivariate Statistical Analysis of the Characteristics of Problem Banks." Journal of Finance 30 (March 1975) 21-38.

15. ________. "Identifying Large Problem/Failed Banks: The Case of Franklin National Bank of New York." Journal of Financial and Quantitative Analysis 12 (December 1977) 779-800.

16. ________. "Identifying "Problem" Banks: How Do the Banking Authorities Measure a Bank's Risk Exposure?" Journal of Money Credit and Banking 10 (May 1978) 184-93.

17. ________. Problem and Failed Institutions in the Commercial Bank Industry. Contemporary Studies in Economic and Financial Analysis, Volume 4. Greenwich, Connecticut: Jai Press Inc., 1979.

18. ________. "The Failure of United States National Bank of San Diego: A Portfolio and Performance Analysis." Journal of Bank Research 6 (Spring 1975) 8-24.

19. Sinkey, Joseph F., Jr., and Walker, David A. "Problem Banks: Identification and Characteristics." Journal of Bank Research 5 (Winter 1975) 208-17.

20. Stuhr, David P., and Van Wicklen, Robert. "Rating the Financial Condition of Banks: A Statistical Approach to Aid Bank Supervision" Monthly Review, Federal Reserve Bank of New York 56 (September 1974) 233-38.

APPENDIX C

EXISTING DISCLOSURE VEHICLES

REPORTS OF CONDITION AND INCOME
("CALL REPORTS")

Every national, state member and insured nonmember commercial bank is required to file a Report of Condition and a Report of Income on a quarterly basis with its Federal supervisory agency. Every mutual savings bank insured by the FDIC is required to submit a Report of Condition quarterly and a Report of Income semiannually. These reports consist of a balance sheet as of the quarter-end date (March 31, etc.), a calendar year-to-date income statement, and supporting financial schedules. In addition, commercial banks over $300 million in total assets file a Large Bank Supplement quarterly. This supplement contains detailed schedules on major asset, liability, income and expense accounts.

The information collected in the Reports of Condition and Income serves a variety of purposes within both governmental and private spheres. Governmental uses include: supervisory purposes, i.e., for monitoring the safety and soundness of individual banks; analysis of general banking developments needed as background for structuring supervisory policy; measurement by the Federal Reserve Board ("FRB") of monetary aggregates, of bank credit, and of flow of funds; analysis of bank credit and monetary developments needed as background for the formulation of monetary policy by the FRB; preparation of balance of payments and national income and product statistics by the Treasury and Commerce Departments; and analysis by various Government agencies of credit that serves the needs of agriculture, industry, housing, international trade and finance and consumers. Many of these governmental uses are paralleled by uses within the private sector, e.g., by the banking industry, by security analysts, and by the academic community. In some cases, an individual item in the reports may serve all or a number of these uses; in other cases, an item may be applicable only to one specialized use.

FILING REQUIREMENTS

Existing Requirements

Commercial banks file different versions of the Reports of Condition and Income based on whether the bank has any foreign offices or whether it has over $100 million in total assets, as follows:

- Banks, regardless of size, that have foreign offices file the most detailed reports. Foreign offices include branches or subsidiaries in foreign countries, branches or subsidiaries in Puerto Rico or U.S. territories and possessions, and Edge Act or Agreement subsidiaries.

International Banking Facilities ("IBFs") are not presently considered foreign offices. These banks utilize the FFIEC 014 - Consolidated Domestic and Foreign Report of Condition, the FFIEC 013 - Standard Report of Income, and the FFIEC 013S - Supplementary Information for the Consolidated Report of Income (a breakdown of selected income and expense items for domestic and foreign offices) and Domestic Office Substatement (a listing of assets and liabilities in such offices).

- Banks that have only domestic offices (including IBFs) and have over $100 million in assets file the second most detailed reports. These banks utilize the FFIEC 012 - Standard Report of Condition and the same form of the Report of Income (FFIEC 013) as above.
- Banks that have only domestic offices (including IBFs) and under $100 million in assets have the option of filing less detailed Reports of Condition and Income or of filing the same reports as larger banks that have only domestic offices. The abbreviated forms are FFIEC 010 - Abbreviated Report of Condition and FFIEC 011 - Abbreviated Report of Income.

Mutual savings banks report on forms which differ from those used by commercial banks. The same set of forms is used by each mutual savings bank regardless of its size.

Proposed Requirements

The commercial bank Call Reports are in the process of being revised and expanded to obtain information necessary to more efficiently monitor individual bank condition and performance. A separate set of forms is being proposed for implementation in 1984 for each of three different categories of banks:

- Banks that have foreign offices. Foreign offices will include the same branches and subsidiaries as at present as well as IBFs. Any bank, regardless of size, whose only "foreign office" is an IBF will fall within this category.
- Banks that have only domestic offices (*i.e.*, no foreign offices as described above) and assets of $100 million or more.
- Banks that have only domestic offices and assets of less than $100 million.

Again, the reporting requirements proposed for each of these classes of banks differ: the foreign office banks' report forms are the most detailed; the reports for domestic only banks of $100 million or over eliminate foreign office detail; and the domestic only banks under $100 million file a somewhat simpler report than the larger banks. Within the last group, domestic only banks under $100 million, banks under $25 million would be afforded further simplification in a few specific areas. Banks under $100 million would no longer have an option to file different reports. The Large Bank Supplement would be eliminated.

Revisions to the mutual savings bank Reports of Condition and Income are contemplated when the commercial bank forms changes have been completed.

New Requirements

In addition to the current and proposed filing requirements already discussed, commercial banks were required to report the amounts of their past due, nonaccrual and renegotiated loans and lease financing receivables on a quarterly basis beginning December 31, 1982. The amount of detail in this report is keyed to the version of the Report of Condition the bank files.

Commercial banks will begin reporting two new schedules quarterly beginning June 30, 1983. Schedule J, "Repricing Opportunities for Selected Balance Sheet Categories," provides information on the bank's sensitivity to interest rate changes. Schedule L, "Commitments and Contingencies," contains information on off balance sheet transactions. The specific reporting requirements for these schedules are also keyed to the version of the Report of Condition the bank files.

CONTENTS OF REPORTS

Report of Condition

The Report of Condition forms for both commercial and mutual savings banks consist of a statement of condition as of the end of a quarter and a number of supporting financial schedules. For both commercial and mutual savings banks, these schedules show the components of the loan portfolio by loan type; the components of the securities portfolio by type of obligor and arrayed by maturity; the components of cash and due from bank accounts; and the components of other assets and other liabilities, if material. Also, a schedule of data used for deposit insurance assessment purposes is required as well as 30-day averages for certain asset and liability accounts. Commercial banks also prepare a schedule on deposit structure by form of deposit and type of depositor and report data on standby letters of credit. Mutual savings banks have additional schedules on maturity distributions of deposits and of borrowed funds as well as supplemental data on the market value of investment securities, pledged securities, certain types of interest bearing deposits, past due and nonaccrual real estate loans, real estate loan commitments, and estimated future real estate loan principal reductions.

Report of Income

The Report of Income for both commercial and mutual savings banks consists of a statement of income for the calendar year-to-date period and is supported by a number of financial sections. These sections show the changes in the equity capital accounts and the allowance for possible loan losses during the period; the components of other income and other expense, if material; the components of the provision for income taxes and extraordinary items; and information on employees, subsidiaries and mergers.

Large Bank Supplement

The Large Bank Supplement for commercial banks consists of seven additional schedules which relate to statement of condition or statement of income accounts. These schedules present data on the remaining maturities of selected loans; the maturity distribution of deposits; the securities held in trading accounts; detailed loan loss experience and reconciliation of the allowance for possible loan losses; interest and fees on loans; short-term extensions of credit; and short-term borrowings.

AVAILABILITY OF REPORTS

The Call Reports are generally available to any interested person in hard copy or on computer tapes for a fee. The reports are due 30 days after the end of a quarter and are available to the public 75 days after the end of the quarter. There are only two portions of the reports which are not available to the public, the 30-to-89 day past due loan and lease amounts on the commercial bank reports (public availability of the past due loans report begins as of June 30, 1983) and some specific deposit data collected only in June from both commercial and mutual savings banks.

BANK PERFORMANCE REPORTS

The Uniform Bank Performance Report ("UBPR") and the Mutual Savings Bank Performance Report ("MSBPR") are analytical tools created for bank supervisory, examination and management purposes. They show, in a convenient format, the historical impact of management decisions and economic conditions on a bank's performance and balance sheet composition. The performance and composition data contained in the reports may be used as an aid in making decisions concerning the adequacy of earnings, liquidity, capital, asset and liability management, and growth management. Bankers and examiners alike may use these reports to further their understanding of bank financial condition and through such understanding become more effective in the performance of their duties.

A UBPR is produced for each insured commercial bank in the United States while an MSBPR is produced for each state-chartered mutual savings bank. The report is computer generated from a data base derived from public and, to a limited extent, nonpublic sources. It contains several years of data which are updated quarterly. Those data are presented in the form of ratios, percentages and dollar amounts computed mainly from Call Reports submitted by the bank. Each performance report also contains corresponding average data for the bank's peer group and percentile rankings for most ratios. These reports, therefore, permit the evaluation of a bank's current condition and trends in its financial performance as well as comparisons of the bank's performance with that of its peer group.

SOURCE OF INFORMATION

The FDIC has the responsibility to maintain the UBPR production system (software and other support programs) and to produce the reports on behalf of the three banking agencies. The information generated in the report is taken from the Call Reports, other regulatory reports (Large Bank Supplements, for example) and a file maintained on an individual bank's structure (branches). The FDIC has also developed its own MSBPR production system since it alone among the three banking agencies has supervisory responsibility over mutual savings banks.

CONTENTS OF REPORT

The UBPR is divided into four parts: summary ratios; statement of income information; statement of condition information; and other information. The data provided within these parts is comprised of three groups: the individual bank's data; data for the peer group; and percentile rankings. The peer group data are derived from a group of banks with similar characteristics including asset size, branch versus nonbranch system bank, and metropolitan versus nonmetropolitan location. There are essentially two formats utilized in the UBPR, one for banks under $300 million in assets and another for banks over $300 million.

The following is a listing and brief description of the UBPR pages.

Introductory page	Contains the bank's name, address, current peer group, any holding company affiliation, and a table of contents.
Page 1	Summary Ratios -- Selected earnings and balance sheet ratios and growth rates providing a synopsis of the bank's condition, performance and growth.
Page 2	Income Statement, Revenues and Expenses -- Historical statements of income in dollars on a tax equivalent basis with one-year and four-years percentage change for income and expense items.
Page 3	Relative Income Statement and Margin Analysis -- Major components of the income statement as a percentage of average assets and the amounts of average earning assets, yields on earning assets, and cost of funds.
Page 4	Noninterest Income and Expense Ratios -- Historical dollar amounts of noninterest income and expense items and these amounts as a percentage of average assets and operating income.

Page 5	Balance Sheet, Asset Section -- Historical end of period amounts of assets, 30-day average assets, and one-year and four-years percentage change in asset items.
Page 6	Balance Sheet, Liabilities and Capital Section -- Same as above, but for liability and capital accounts.
Page 7	Balance Sheet, Percentage Composition of Assets and Liabilities -- The major components of the statement of condition are averaged and presented as a percentage of average total assets.
Page 8	Analysis of Loan Loss Reserve and Loan Mix -- Historical dollar reconciliation of the loan loss reserve, ratios of provisions, chargeoffs, recoveries, net loan losses, and the reserve balance to asset and loan averages. Also, the principal categories of loans as a percentage of gross loans, and changes in the composition of asset, loan, and liability mixes.
Page 8A	Analysis of Nonperforming Loans -- Not available to the public until the Call Reports as of June 30, 1983.
Page 9	Sources and Uses of Funds -- Changes in specific balance sheet data by quarters and by year.
Page 10	Margin Sensitivity Analysis -- End of period assets and liabilities categorized by market-rate versus fixed-rate, and expressed as a percentage of total assets.
Page 11	Liquidity and Investment Portfolio -- Dollar information and ratios which indicate a bank's liquidity position, and the principal components of the investment portfolio as a percentage of total securities.
Page 12	Capital Analysis -- End of period amounts, reconcilement of account changes during the period, and selected ratios.
Page 13	Summary Information for Banks in State -- Dollar and ratio information for all banks in the state and by asset category of banks in the state.
Page 14	Foreign Office Trends -- Where applicable, dollar amounts of the most significant types of assets and liabilities in foreign offices and related ratios.

It should be noted that the UBPR is being revised to incorporate the additional data to be collected in the new schedules to the Call Reports. All banks will have a page related to nonperforming loans (page 8A) which will utilize the information filed by banks on past due, nonaccrual and renegotiated loans and leases. Quarterly income data is now being reported by banks and therefore all bank UBPRs can be updated quarterly. Finally, the new Schedule J, "Repricing Opportunities for Selected Balance Sheet Categories," and Schedule L, "Commitments and Contingencies," will be incorporated into the UBPR.

The tables in the MSBPR cover the same four areas as the parts of the UBPR. The report provides four columns of peer group data for comparison with the bank's data. The peer groups have been formed from (1) all mutual savings banks in the nation, (2) all mutuals in the state, (3) all mutuals in a geographic reference group, and (4) all mutuals in the nation with similar asset size. The percentile ranking that is provided relates to the bank's ranking within the national asset size peer group.

The following is a listing and brief description of the MSBPR pages.

Introductory page	Contains the bank's name, address, number of branches, peer group descriptions, and a table of contents.
Page 1	Summary Ratios -- Selected earnings and balance sheet ratios and growth rates and asset quality data providing a synopsis of the bank's condition, performance, and growth.
Page 2	Income and Expense Ratios -- Income statement elements as a percentage of average assets, cost and yield factors, ratios permitting an analysis of net interest margin, and overhead ratios.
Page 3	Balance Sheet Composition -- Individual asset, liability, and surplus accounts as a percentage of end of period total assets.
Page 4	Loan and Investment Analysis -- Loan categories as a percentage of total loans, securities by maturity as a percentage of total securities, subquality real estate loans as a percentage of real estate loans, ratios of provisions, chargeoffs, recoveries, net loan losses, and the reserve balance to loan balances, and comparisons of the book and market values of investments.
Page 5	Liquidity and Rate Sensitivity -- Ratios which indicate a bank's liquidity and rate sensitivity position and growth rates for selected balance sheet components related to liquidity and sensitivity.
Page 6	Balance Sheet History -- Historical end of period dollar amounts of asset, liability, and surplus accounts.

Page 7	Balance Sheet History, Memoranda -- Historical end of period dollar amounts of time deposits and other borrowed money by maturity, 30-day averages for selected balance sheet categories, market values of bonds and stock, selected real estate loan data, and a reconciliation of surplus accounts.
Page 8	Average Balance Sheet -- Average dollar amounts for individual asset, liability, and surplus accounts for the year to date.
Page 9	Income Statement History -- Historical statements of income in dollars.

AVAILABILITY

Both the UBPRs and MSBPRs are available to any interested person for a fee approximately 90 days after the end of a quarter. Each bank is provided a copy of its own performance report free of charge. Commercial bank ratios using the 30- to 89-day past due loan and lease data will be provided to the regulator, but will be withheld from the general public.

INSIDER LOAN DISCLOSURES

Form FFIEC 003 was designed to be used by banks in fulfilling the annual insider loan reporting requirements imposed by Titles VIII and IX of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 ("FIRA"). The filing of the report is mandatory and the information contained therein is publicly available from the bank's regulatory agency as well as from the institution itself. Each reporting bank must list on this form (a) the principal shareholders of the bank, if any; (b) the names of executive officers and/or principal shareholders of the bank who were, or whose related interests were, indebted to the bank during the year, and the aggregate amount of such indebtedness for all named persons; and (c) the names of executive officers and/or principal shareholders of the reporting bank who filed a report with the bank at year-end on indebtedness to its correspondent banks during the year, and the aggregate amount of such indebtedness for all named persons.

Title IV of the Garn-St Germain Depository Institutions Act of 1982 authorized the Federal banking agencies to issue rules and regulations dealing with: (1) reporting and disclosure of loans by banks to their own executive officers and principal shareholders; and (2) reporting and disclosure of loans by correspondent banks to a reporting bank's executive officers and principal shareholders. These authorizations represent amendments to Titles VIII and IX of FIRA, the original provisions of which will remain in effect until such time as new regulations become effective.

SECURITIES LAWS

The two Federal securities laws, the Securities Act of 1933 ("1933 Act") and the Securities Exchange Act of 1934 ("1934 Act"), as amended, require certain public disclosures be made by banks and bank holding companies.

PUBLIC OFFERINGS OF SECURITIES

The 1933 Act requires a company to disclose its officers, directors, principal shareholders, management's remuneration, and other business information and provide financial statements certified by an independent public accountant to potential investors before these investors buy the debt or equity of the company. Banks are specifically exempt from the 1933 Act, but bank holding companies, of which almost all large banks are a part, are covered by the requirements of the 1933 Act.

Bank holding companies must therefore register any public sale of securities (equity or debt) with the Securities and Exchange Commission ("SEC"), and provide a prospectus including the mandated information to each purchaser prior to the purchase of securities; however, exemptions exist for certain offerings of less than $5 million.

Although exempt from the 1933 Act, banks with national charters under the Office of the Comptroller of the Currency's ("OCC") regulations, 12 CFR Part 16, must file and have declared effective an offering circular which is to be provided to every purchaser of the offering. This information is less extensive than that required by the SEC, and the financial statements need not be certified by an independent public accountant. Exemptions exist for sales of less than $500,000 and an abbreviated form is available for sales under $2 million.

State-chartered banks that are members of the Federal Reserve System ("FRS") have no Federal requirements governing them if they wish to sell securities to the public, with the exception of the general fraud prohibitions in Section 17 of the 1933 Act which apply to any bank or company in the United States. The FRB does not have any filing or offering circular requirements.

State-chartered banks that are not FRS members also have no Federal requirement to file or provide an offering circular. However, the FDIC has adopted a Statement of Policy Regarding Use of Offering Circulars in Connection with Public Distribution of Bank Securities which applies to state nonmember banks. The policy statement lists 12 basic topics which should be included in every offering circular.

Many sales of securities are effected through the use of offering circulars as a result of FDIC administrative actions requiring additional bank capital. Such orders generally mandate the use of an offering circular acceptable to the FDIC staff. In 1982, 38 offering circulars were submitted to the FDIC's Washington Office for suggestions or review.

PUBLICLY HELD SECURITIES

The 1934 Act requires that equity securities of companies with over 500 stockholders and $1 million in assets be registered and that these companies provide their stockholders with proxy statements and with annual reports including financial statements. In addition, these "registered" companies must file quarterly reports and provide other information on current company events, officer, director and principal stockholder security transactions, and tender offers.

Although banks are not required to register or file this information with the SEC, bank holding companies must do so. Section 12(i) of the 1934 Act provides for banks to register and file periodic reports with their respective regulatory agency.

The following four categories of disclosure exist under the 1934 Act:

Registered bank holding companies
Registered banks
Nonregistered nonholding company banks
Nonregistered bank holding companies

Registered bank holding companies

- Securities disclosure is regulated by the SEC.
- Stock must be registered if a bank holding company has over 500 stockholders and over $3 million in assets.[1]
- Approximately 2,600 or 18 percent of insured commercial banks are owned by registered bank holding companies.
- A bank holding company must prepare proxy statements, annual reports (Form 10-K), and other periodic reports, as well as annual reports to stockholders.
- Financial statements
  - must be prepared according to generally accepted accounting principles with footnote explanations, and
  - must be certified by an independent public accountant.

---

[1] Although the 1934 Act specifies $1 million in assets, the SEC has exempted companies under $3 million to account for inflation. However, both amounts are so low as to make it virtually irrelevant when discussing banks.

Registered banks

- Securities disclosure is regulated by appropriate regulatory agency -- OCC, FRB or FDIC.
- Stock must be registered if bank has over 500 shareholders and over $1 million in assets.
- Approximately 700 or five percent of insured commercial banks are registered banks.
- Banks must provide proxy statement, annual reports (Form F-2), and other periodic reports, as well as annual reports to stockholders.
- Financial statements:
    - must be prepared according to generally accepted accounting principles with footnote explanations, and
    - must be verified by the bank's principal accounting officer and internal auditor if not certified by an independent public accountant.

Nonregistered Nonholding Company Banks

State banks

- Stock held by less than 500 stockholders or bank has less than $1 million in assets.
- Securities disclosure not regulated by Federal statute.
- Approximately 9,500 or 66 percent of insured commercial banks are nonregistered state banks. Of these, approximately 1,000 are member banks and approximately 8,500 are nonmember banks. (These numbers include nonregistered banks owned by registered holding companies.)
- Banks have no requirements for stockholder reports or proxy statements under Federal securities laws.
- Publicly available financial information is in Call Reports.

National Banks

- Stock held by less than 500 stockholders or bank has less than $1 million in assets.
- Annual report must be available to stockholders although not reviewed by OCC (12 CFR Part 18).
- Approximately 4,200 or 29 percent of insured commercial banks are nonregistered national banks. (These numbers include nonregistered banks owned by registered holding companies.)

- No other requirement for filing proxy statements or stockholders reports.
- Other publicly available information is in Call Reports.

Nonregistered Bank Holding Companies

- Stock in holding company held by less than 500 shareholders or holding company has less than $3 million in assets.
- Securities disclosure not regulated by Federal statute.
- Bank holding company regulated in areas other than securities law by FRB under the Bank Holding Act of 1956, as amended.
- Bank holding company must file Form Y-6 and, if over $50 million in assets, Form Y-9 with the FRB, both of which are publicly available upon request.
- Holding company has no requirement for proxy statements or annual reports to stockholders. Also, no filing of other public reports.
- Financial statements must follow generally accepted accounting principles.

In addition to the requirements outlined above under the 1934 Act, all banks and bank holding companies are subject to the prohibitions in Section 10(b) and its related rules against the use of manipulative or deceptive practices and false and misleading information in the sale or purchase of securities. Section 14(e) and its rules apply to all tender offers including those for all bank and bank holding company stock.

STATE REQUIRED DISCLOSURE

The 50 states have varying requirements for disclosure of information by state-chartered banks.

The New York Superintendent of Banks, for example, has the authority to give final approval to the issuance of securities by state banks. Under this authority, the state staff reviews all offering circulars for these offerings. In addition, all banks whose securities are not registered under the 1934 Act must provide stockholders with an annual report including financial statements. The latter need not be certified by an independent public accountant, but must provide certain footnote explanations. Although there are no separate state call reports (New York uses the Federal Call Report data), state banks are required to publish their Call Report Statement of Condition semiannually.

Ohio statutes require quarterly publication of the balance sheet of the Report of Condition. Banks in Ohio must also file with the state a Summary Report by June 30 each year which lists directors and officers and contains a very brief summary of the balance sheet which is available to the public. The only other publicly available information comes from various corporate applications. Banks must publish that an application has been filed with the state and, later, that the transaction has been effected. Only banks under administrative orders have their disclosure materials reviewed by the staff of the Superintendent of Banks prior to public offerings.

California law also requires the Report of Condition to be published quarterly, and the Report of Income is available upon request. Banks come under the General Corporate Code in California, and are required to hold an annual meeting each year and to provide an annual report to stockholders prior to the meeting which includes a balance sheet, income statement, statement of financial position, and an accountant's report or a certificate of verifying officer. If the bank wants to establish a stock option plan, increase authorized shares, or sell securities, a permit is needed from the state. Prior to issuing that permit, the staff of the California Superintendent of Banks requires and reviews the proxy statement or prospectus, as appropriate, used to effect the transaction.

DISCLOSURE UNDER THE BANK HOLDING COMPANY ACT OF 1956

Disclosure of the financial condition and organizational structure of bank holding company organizations is available from two reports submitted to the FRS, the Y-6 (Annual Report of Domestic Bank Holding Companies) and the Y-9 (Bank Holding Company Financial Supplement).

To the extent that the data is provided on a preprinted format (Y-9 in its entirety and Y-6 in portions), the information contained in the documents is available on computer tape for subscribers. Copies of either report may also be requested from the FRS. The Y-6 presents a broad and theoretically in-depth view of the structure and financial condition of a holding company. For analysis of the financial condition of a given bank within the holding company, however, the Y-6 is limited because it lacks detailed data for each individual bank subsidiary. Narrative disclosure of matters which could be considered vital to an in-depth analysis of the banks within the organization (such as administrative orders by regulatory agencies) is not required. However, information concerning subsidiaries, related interests, and loans to insiders is valuable to the analyst.

FORM Y-6 (ANNUAL REPORT OF DOMESTIC BANK HOLDING COMPANIES)

Filing Requirements

Must be filed by any domestic company that meets the definition of a "bank holding company" under the Bank Holding Company Act (a qualifying "foreign banking organization" would submit a Y-7).

A single report may be filed by tiered holding companies with specified items answered separately.

Report is due three months after the end of the organization's fiscal year.

Availability of Information

The reports submitted are available on an individual respondent basis.

The bank holding company may request in writing confidential treatment for information contained in the report by substantiating that release of such data would result in an invasion of privacy or result in substantial harm to the organization's competitive position.

The FRB may determine that the disclosure of such information (for which confidentiality is requested) is in the public interest.

Items Contained in Report

Financial Statements

Consolidated and parent only two year comparative financial statements, including balance sheets, income statements, changes in capital accounts and changes in financial position (consolidated financial statements need not be submitted by one bank holding companies with less than $100 million in total banking assets).

Annual Reports

If prepared in the normal course of business, the bank holding company's (and any subsidiary's) most recent Form 10-K and annual report to shareholders.

Information on Subsidiaries (Schedule A)

Must be completed for each bank and nonbank (foreign and domestic) subsidiary of the bank holding company; grouping of subsidiaries engaged in consumer or sales financing or mortgage banking is permitted.

Structural data include identification of subsidiary, type of business engaged in, information on ownership of the subsidiary within the bank holding company's organization including types and percentages of voting shares owned or controlled, number of offices and [illegible] in which offices are operated.

Financial data include information concerning investment in subsidiaries as well as certain intracompany transactions and selected balance sheet and income statement data of the subsidiaries.

Information Included on Regulated Investments (Schedule B)

Must be completed for each bank and nonbank (foreign and domestic) regulated investment which is not otherwise regarded as an investment.

Structural information includes ownership information within the holding company's organization, types and percentages of voting share ownership, and a description of the business activities.

Financial data includes information on the investment.

Activities of Parent Bank Holding Company (Schedule C)

Provides listing of business activities currently conducted by the parent company and lists whether they are conducted in the United States.

Provides listings of business activities commenced or terminated by the parent company during the year.

Provides number of existing offices and the change in this number over the last fiscal year.

Information on Terminations (Schedule D)

Provides information for any entity that ceased being a part of the bank holding company organization during the past year.

Organization Chart

Includes a chart showing the bank holding company's direct and indirect ownership or control of all its bank and nonbank subsidiaries.

Shareholders and Directors and Officers

A list of each shareholder that directly or indirectly owns, controls, or holds with power to vote five percent or more of any class of voting securities of the bank holding company along with the shareholder's country of citizenship and the number and percentage of shares owned or controlled.

A separate list of each principal shareholder, director, or executive officer together with the title or position of each within the holding company and/or other companies, principal occupation, and number and percentage of shares owned.

Insider Loan Information

If the aggregate of loans to insiders and their interests is more than ten percent of the equity capital accounts of the bank holding company, each loan to an insider and his interests must be listed and the following disclosed: name and title of borrower, lending institution, date originated, original amount of the loan and current balance, original and current interest rate, description of collateral, and lending institution's interest rate on comparable loans to borrowers other than insiders.

FORM Y-9 (BANK HOLDING COMPANY FINANCIAL SUPPLEMENT)

Filing Requirements

Required of holding companies with total consolidated assets of $50 million or more.

Bank holding companies with total consolidated assets of $50 to $100 million file parent only balance sheets and income statements at year-end.

Bank holding companies with total consolidated assets of $100 to 300 million file consolidated and parent only balance sheets and income statements at year-end.

Bank holding companies with $300 million or more in consolidated assets must file consolidated and parent only balance sheets and income statements at the end of the first six months of their fiscal year and at year-end.

Availability of Information

Publicly available after the bank holding company has released its financial statements to the public or 90 days after the end of the reporting period, whichever comes first.

Confidentiality is usually accorded during the interim; in some instances information can be released during this period with notification to the respondent holding company.

APPENDIX D

ASSESSMENT PROCEDURES AND ISSUES

BASIC ASSESSMENT RATE

In 1935, Congress set the basic annual assessment rate for deposit insurance at 1/12th of one percent of total (adjusted) deposits. Adoption of this rate was based upon a combination of factors rather than upon rigorous actuarial methods. It was calculated that during the period 1865-1933, an annual average assessment rate of about 1/7th of one percent of total deposits would have been required to cover the actual losses on deposit balances in failed banks. However, if certain "crisis" years in which losses were unusually high were eliminated, the necessary rate would have been lowered to 1/12th of one percent. Adoption of the lower rate was justified on the grounds that many banking reforms and improvements had occurred to strengthen the banking system and prevent bank failures. These included deposit insurance, better bank supervision, and revised banking laws.

ASSESSMENT CREDIT

In 1950, Congress reduced the effective assessment rate by providing for an assessment credit to banks. The credit was set at 60 percent of the FDIC's net assessment income (gross assessments minus administrative expenses and operating expenses and insurance losses). Legislation enacted in 1960 raised the credit to 66 2/3 percent and reduced deductions from assessable deposits for some banks. In 1980, the Depository Institutions Deregulation and Monetary Control Act provided for a reduction in the credit to 60 percent. The Act authorized the Board of Directors of the FDIC to make adjustments to the credit to maintain the Deposit Insurance Fund between 1.25 and 1.40 percent of estimated insured deposits. The Act also mandated adjustments when the Fund fell below 1.10 percent or rose above 1.40 percent of insured deposits.

METHOD OF ASSESSMENT COMPUTATION

Every insured bank pays its assessment twice annually based upon deposit calculations for the preceding two quarters. A certified statement and the payment due must be submitted on or before January 31 and July 31. Each bank's gross assessment for each semiannual period is the basic assessment rate (1/12th of one percent) multiplied by one-half of the average of its assessable deposits on the preceding two Call Report dates. Assessments are paid by drawing on the available assessment credit and paying the remainder in cash. If a credit is not used when initially available, it may be carried over to the bank's future assessment dates. Since credits declared by the FDIC become available to insured banks initially on July 1 of the following year, almost all cash assessments are received by the FDIC with the January payment.[1]

Total deposits are adjusted in several ways to compute assessable deposits. Deductions from total deposits are permitted for unposted debits of items in possession of the bank. Reported demand deposits are adjusted upward by the amount of uninvested trust funds shown separately in the Report of Condition and by other unposted deposits. If the amounts of unposted items are not shown in the bank's records, they may be determined (for only a few banks at present) by an "experience" factor. For items in process that have not been collected (referred to as "float"), deductions of 16 2/3 percent of adjusted demand deposits, and one percent of adjusted savings and time deposits, are permitted.

SUMMARY OF TECHNICAL ISSUES

Some technical issues have been raised concerning assessment procedures. These involve the deductions for float, the procedures for averaging deposits, and the assessment of interbank deposits.

Because of operational problems in calculating the float allowance for individual banks, uniform percentage deductions were introduced in 1961. Fixed rate deductions involve some significant issues. Although NOW accounts and other new "transactions-type" accounts have come into use nationwide, traditional demand and savings time categories still are used for computing the float allowance. There is also an equity issue involved. For some institutions cash items run to 30 percent or more of demand deposits, while for others the existing system is advantageous since the actual cash items are below the allowed percentages. Because of this problem, and the fact that float does not affect the liability of the FDIC in a closed bank situation, the float adjustment should be deleted.

Under the deposit insurance legislation enacted in 1935, each bank calculated its assessment from the daily average of its deposits for the preceding six months. The Federal Deposit Insurance Act of 1950 changed the basis to the two date quarterly average used at present. The use of a two-date average of deposits may result in distortions due to irregular changes in deposits at the end of the period and in some cases, intentional distortions to reduce assessments. Use of the average of daily deposits would tend to eliminate or reduce these distortions. However, use of daily average deposits would add to time and paperwork burdens for banks. Moreover, neither the current Call Report nor their proposed changes require all banks to report daily averages of demand and time deposits. On balance, the costs involved in using daily averages of deposits would outweigh the potential benefits.

---

[1] Because the assessment credit was greatly reduced in 1981 and 1982 as a result of higher insurance losses, most of the assessments due on July 1, 1982 were paid in cash. This will occur also on July 1, 1983.

APPENDIX E

THE FINANCIAL STATEMENTS OF THE FEDERAL DEPOSIT INSURANCE CORPORATION

INCOME AND EXPENSES

Table E1 contains the Income Statement of the FDIC.

Gross assessments are 1/12th of one percent of total (adjusted) deposits which amounted to about $1.1 billion in 1982. Net assessment income is comprised of gross assessments less administrative expenses and provisions for insurance losses. Sixty percent of net assessment income is returned to banks in the form of an assessment credit. Net assessments represent gross assessments less the credit.

The other principal source of the FDIC's income is the interest on its portfolio of U.S. Treasury securities which was about $1.4 billion in 1982. Most other income derives from interest earned on notes receivable which were acquired in assistance transactions.

In addition to its administrative expenses, the FDIC incurred interest expense on notes payable to acquiring banks and to the Federal Reserve that arose in connection with assisted savings bank mergers. Insurance expenses are those incurred in connection with the handling of failed banks, but not billable to specific liquidations. The FDIC's policy is to establish an allowance for losses on assets acquired at the time an insured bank fails and expense the provision for loss. These allowances are reviewed periodically or as conditions require.

The cost to the FDIC of future payments in merger assistance transactions such as income maintenance agreements and loss indemnifications with savings banks is the estimated present value of the future payments at the time of the transactions. Adjustments are made in the FDIC's costs during the course of the payment period to reflect expected changes in future cash payments.

Net income after subtracting expenses and losses from total income is the amount added to the Deposit Insurance Fund. In 1982, this increase was approximately $1.5 billion.

ASSETS AND LIABILITIES

Table E2 contains the balance sheet of the FDIC.

The FDIC's assets consist of cash, investment securities, office buildings, and assets acquired in various assistance transactions involving failed banks. These assets totaled over $15.2 billion at year-end 1982.

Cash received but not used to cover operating expenses or disbursements related to failing banks and liquidation activities is invested in U. S. Treasury securities. At year-end 1982, U. S. Treasury securities accounted for about 89 percent of the FDIC's total assets. The maturity structure of the securities portfolio as of year-end 1981 and 1982 were as follows:

	1982	1981
Less than 1 year	31.2%	34.3%
1-5 years	54.6	40.7
5-10 years	13.7	24.4
Over 10 years	0.5	0.6

Some assets of the FDIC are derived from providing capital assistance to banks. Notes receivable are sometimes acquired from insured banks in facilitating merger agreements, purchase and assumptions of failing banks, and in other assistance arrangements. Net worth certificates have also been acquired to maintain or increase the net worth of insured banks in accordance with the Garn-St Germain Depository Institutions Act of 1982. To qualify for this assistance, institutions must have a net worth equal to or less than three percent of assets and have incurred losses during the previous two quarters. Certificates are issued for a portion of the losses. In consideration for the purchase of a net worth certificate, the FDIC issues its nonnegotiable, floating rate promissory notes of equal principal value. By year-end 1982, the FDIC had assisted 15 insured mutual savings banks through the purchase of net worth certificates totaling $174.5 million.

In a deposit payoff, the FDIC acquires a claim against the receivership of the closed bank and the FDIC receives a pro rata share of the proceeds from the liquidation of the assets. In a purchase and assumption transaction, the FDIC takes over the assets of the failing institution which are not taken by the acquiring bank. An allowance for losses is established to reflect the shortfall between the FDIC's advances and expected recoveries on assets to be liquidated. The 1982 figure of $712 million under Equity in Acquired Assets reflects the FDIC's interest in failed bank assets, net of loss allowance.

The FDIC's liabilities totaled $1.5 billion at year-end 1982. The principal liabilities are incurred in bank assistance transactions.

The FDIC's total assets less its liabilities equals the Deposit Insurance Fund, which amounted to about $13.8 billion on December 31, 1982.

TABLE E1

FEDERAL DEPOSIT INSURANCE CORPORATION

COMPARATIVE STATEMENT OF INCOME AND THE DEPOSIT INSURANCE FUND (In thousands)	For the twelve months ended December 31, 1982	December 31, 1981
INCOME:		
Gross assessments earned	$ 1,109,288	$ 1,040,940
Less: Provision for assessment credits	96,553	119,024
TOTAL	1,012,735	921,916
Interest on U. S. Treasury obligations	1,116,216	985,417
Amortization of premiums and discounts (net)	253,750	130,043
TOTAL	1,369,966	1,115,460
Interest earned on notes receivable	79,178	31,924
Interest received on assets in liquidation	53,888	647
Other income	8,869	4,743
TOTAL INCOME	2,524,636	2,074,690
EXPENSES AND LOSSES:		
Administrative and operating expenses (net)	129,927	127,185
Merger assistance losses and expenses (net)	681,129	387,712
Provision for insurance losses (net)	126,436	320,412
Interest expense on FRB indebtedness	54,178	9,386
Nonrecoverable insurance expenses	8,162	3,396
TOTAL EXPENSES AND LOSSES	999,832	848,091
NET INCOME	1,524,804	1,226,599
DEPOSIT INSURANCE FUND - JANUARY 1	12,246,140	11,019,541
DEPOSIT INSURANCE FUND - DECEMBER 31	$13,770,944	$12,246,140

TABLE E2

FEDERAL DEPOSIT INSURANCE CORPORATION

COMPARATIVE STATEMENT OF FINANCIAL POSITION (In thousands)

	December 31,	
	1982	1981
ASSETS		
Cash	1,335	382
Investments in U.S. Treasury Obligations	13,559,481	12,236,398
Interest and Notes Receivable Related to Assistance	742,165	430,317
Net Worth Certificates	174,529	--
Other Receivables and Prepaid Items	9,793	4,542
Equity in Acquired Assets (net)	712,069	547,214
Land and Office Buildings (net)	34,153	22,932
	15,233,525	13,241,785
LIABILITIES		
Accounts Payable, Liability for Accrued Leave, etc.	66,150	23,290
Due Insured Banks (Assessment Credit)	96,181	128,872
Notes Payable	836,579	462,531
Liability for Income Maintenance Agreements	276,595	379,542
Promissory (exchange) Notes	174,529	--
Unpaid Depositor Claims	9,547	1,410
Allowance for Litigation	3,000	--
DEPOSIT INSURANCE FUND	13,770,944	12,246,140
TOTAL LIABILITIES AND DEPOSIT INSURANCE FUND	15,233,525	13,241,785

APPENDIX F

SMALL DEPOSITOR PROTECTION

INTRODUCTION

Before concluding that various risk-sharing approaches discussed in Chapter III are desirable and feasible, the FDIC studied the potential impact on the small depositor. There is no doubt that, as a group, small depositors have fared extremely well under the present insurance framework. In the 620 failures of insured bank cases through year-end 1982, 99.8 percent of all depositors had their deposits paid in full and 98.9 percent of all deposits have been recovered. Moreover, estimates show that approximately 95 percent of all deposit accounts (as opposed to dollar volume) are still within the $100,000 insurance limit, so even with a risk-sharing policy, the small depositor will remain adequately protected.

There are several types of uninsured deposits where increased insurance protection could be justified because the depositors are unable to analyze bank risk or they cannot control balances on a daily basis. These include transaction accounts such as payroll and lock-box accounts, unsophisticated depositors, depositors with limited banking choices, some pension funds as well as IRA and Keogh accounts. Methods for increasing deposit insurance coverage for those accounts were considered, but for most of the accounts identified, no effective way was found to isolate them from other similar accounts in the same deposit category. For example, payroll and lock-box accounts cannot be segregated by definition from other transaction accounts; therefore, any increase in insurance coverage for those two accounts would result in a similar insurance increase for all transaction accounts. As the deregulation of deposit accounts continues, even the definition of transaction accounts may be blurred with time accounts which would further complicate the identification problem. Only IRA and Keogh accounts were found to be isolated enough to permit increased insurance coverage without significantly reducing market discipline.

Increasing the statutory $100,000 insurance limit was also considered and rejected because a higher limit would increase the potential for brokering insured deposits. This practice of dividing large deposits among banks to obtain maximum insurance coverage increases risk to the insurance fund and can thwart efforts toward market discipline.

SMALL DEPOSITOR DEFINED

The FDIC considers a "small depositor" to be one who is generally incapable of fully understanding bank risk and who may overreact to rumors concerning a bank's solvency. Small depositors also are likely to be more seriously affected by a loss incurred in a bank failure. They desire a reasonable rate of return, but their primary needs are safety and liquidity.

Protecting these unsophisticated depositors is basic to preventing bank runs. Unfortunately, it is difficult to know which depositors meet these criteria. When they are identified, it is even more difficult to protect only the unsophisticated without increasing protection for all similar deposit accounts.

For example, discussions with depositors in failed banks suggest that it may be incorrect to assume that all depositors with more than $100,000 are necessarily sophisticated enough to provide any meaningful discipline and among those who are, some exhibit characteristics of the unsophisticated depositors simply because they have limited banking choices. Still others are limited because their needs for funding or other services restrict them to particular banks. None of these accounts can be easily isolated to permit increased insurance protection.

PRESENT PROTECTION LEVEL

In order to establish the adequacy of protection currently provided to small depositors, the amount of loss suffered by depositors of insured failed banks was reviewed. From 1934 through 1982, the FDIC disbursed nearly $7.8 billion in the 620 closed bank cases and has absorbed potential losses of over $1.8 billion. Depositor losses have totaled only $51 million, or less than 0.3 percent of the total deposits held by all failed institutions. This nominal depositor loss is at least partly attributable to the number of FDIC-assisted deposit assumption transactions. Under a depositor risk-sharing alternative, losses would resemble, but not be as great as, those incurred in deposit payoff cases. While such losses can vary, on average all but about eight percent of uninsured balances are eventually recovered. This loss rate does not reflect the opportunity costs of not having access to funds during the several years needed for many liquidations. Adding these costs could at least double the loss rates.

Even if payoffs occur more frequently, most depositors with more than $100,000 are sophisticated enough to protect themselves. Many can spread their funds among different banks and others will become more aware of the risk at their banks. There will still be some who will not be able to control their risks. These do not hold a significant portion of deposits, but it may be appropriate to consider ways of increasing their protection — ways that do not thwart efforts to increase market discipline.

ESTIMATED UNINSURED DEPOSITS

In identifying unsophisticated depositors, the amount of uninsured domestic deposits was estimated and then an attempt was made to determine who holds the large deposits. Of the FDIC-insured institutions, mutual savings banks hold only about three percent in uninsured deposits, but aggregate uninsured deposits in commercial banks are significant, particularly in the larger institutions.

The percentage of large deposits varies with bank size, as shown in Table F1. The table shows that approximately 25 percent of the $1.5 trillion in domestic deposits held by commercial banks are in accounts with balances in excess of $100,000. When foreign deposits are included, approximately 40 percent of all deposits held by commercial banks are in accounts with balances above the statutory $100,000 insurance limit.

TABLE F1

PERCENTAGE OF
COMMERCIAL BANK DEPOSITS
WITH BALANCES ABOVE $100,000
March 31, 1982
Report of Condition

Commercial Bank Size by Deposits (in Millions)	Large Domestic Deposits Percent*	Total Large Deposits Percent**
0.0 - 99.9	13	13
100.0 - 299.9	18	18
300.0 - 999.9	22	22
1,000.0 - 9,999.9	28	36
10,000.0 & over	43	71
All Insured Commercial Banks	25	40

*Percent of total domestic deposits in domestic accounts above $100,000

**Percent of total deposits (domestic and foreign) in domestic accounts above $100,000

Table F1 shows that a relatively small percentage of deposits in banks with less than $100 million in deposits are in large accounts, while over 40 percent of domestic deposits in banks with over $10 billion in deposits are in such accounts. Depositors in large banks have enjoyed full protection since no failure of a bank over $1 billion in deposits has ever been handled through a payoff. In a depositor risk-sharing plan, the potential for loss exposure for a greater portion of the large bank depositor base is increased. To the extent that a risk-sharing plan results in less frequent use of assisted deposit assumption transactions for large banks, there will be higher and more uniform risk exposure for these depositors.

To assist in the analysis of uninsured deposit accounts, examiners from all three bank regulatory agencies collected domestic deposit data in about 350 commercial and mutual savings banks that were under examination between January 6 and January 21, 1983. The survey data were used to estimate uninsured balances by type of deposit and to gain some insight into the types of depositors that hold large accounts. The results corresponded with estimates derived from more comprehensive surveys conducted in earlier years.

Tables F2 and F3 summarize the survey findings. Uninsured balances are shown for different depositor groups including deposits of individuals, partnerships and corporations (IPC); deposits of governmental bodies (Public Funds) and all others which are described later. For each group, demand and time and savings deposits were further broken down to reflect accounts between $100,000 and $250,000; and accounts over $250,000. Amounts in Table F3 have been adjusted to reflect only the uninsured portion.

TABLE F2
ESTIMATED NUMBER OF ACCOUNTS ABOVE $100,000
(In Thousands)

	Number of Accounts $100,001 to $250,000	Number of Accounts Over $250,000	Total Number of Accounts Over $100,000
Demand-IPC	250	123	373
Savings-IPC	143	15	158
Time-IPC	413	173	586
Public Funds-Dem	17	13	30
Public Funds-T&S	60	60	120
All Others	49	33	82
Totals	932	417	1,349

TABLE F3
ESTIMATED UNINSURED DEPOSITS*
(In Millions)

	Accounts $100,001 to $250,000		Accounts Over $250,000		Total Uninsured Above $100,000	
	Amount	Percent	Amount	Percent	Amount	Percent
Demand-IPC	11,245	17	114,018	33	125,263	30
Savings-IPC	2,399	4	7,229	2	9,628	2
Time-IPC	46,433	69	124,253	35	170,686	41
Public Funds-Dem	1,167	1	14,549	4	15,716	4
Public Funds-T&S	4,273	6	51,221	15	55,494	13
All Others	2,216	3	39,753	11	41,969	10
Totals	67,733	100	351,023	100	418,756	100

*Excludes the $100,000 insured portion of each account.

Estimated Total U.S. Domestic Deposits	$1,560 billion	100%
Estimated Insured U.S. Domestic Deposits	1,141 billion	73%
Estimated Uninsured U.S. Domestic Deposits	419 billion	27%

LARGE DEPOSIT HOLDERS

Each of the six deposit categories in Table F3 was reviewed, first to identify the account holders within each category, and second to decide whether increased protection would be appropriate. This preliminary review revealed that only the Demand (IPC) and Time (IPC) accounts contained uninsured deposit holders who could realistically be considered for increased protection. The other categories were found to be almost fully protected or included only presumed sophisticated investors.

For example, most uninsured public deposits are protected through pledging requirements or preference statutes. These deposits do not need increased insurance protection although increased protection would reduce the need for pledging requirements. Savings accounts do not require increased protection because only four percent of the balances are exposed. Moreover, the phaseout of deposit regulations will continue to blur the distinction between savings deposits and other types of accounts. Isolating these accounts from others will be virtually impossible.

The All Others category includes deposits of foreign governments and official institutions, commercial banks in the United States, U.S. branches of foreign banks and agencies of foreign banks. All of these depositors should be sophisticated enough to analyze bank risk.

Time Deposits

The time deposit category is the largest of the six categories identified in the large depositor survey. The volume is estimated at $170 billion or 41 percent of all domestic uninsured deposits. Virtually all of the uninsured time deposits are in time certificates of deposit (CDs). Table F4 shows an estimated percentage breakdown of the holders.

TABLE F4

Estimated Percentage Breakdown of the Large CD Market	
Households	25%
Business	15%
State & Local Government	15%
Money Market Funds	15%
Trust Departments	10%
Pension Funds	10%
Foreign	7%
Thrifts	3%
	100%

The table indicates approximately 75 percent of the CD market is composed of those who are considered sophisticated investors. The 25 percent composed of the households may include some unsophisticated depositors.

In order to evaluate depositor understanding of bank risk, a limited number of large CD investors were contacted. These included money fund managers, pension fund managers, individual and small business investors, and corporate treasurers. The money fund and pension fund managers claimed their investment decisions were made only after performing an extensive internal analysis of bank risk, often with input from bank rating services. This group confers directly with bankers and uses various forms of publicly-available information to assist in their analysis.

Corporate treasurers did not appear as thorough in their analysis of bank risk. Most did not conduct any in-depth analysis of the banks before investing in a bank CD because they view their CDs more as a temporary placement of excess funds than as an investment. Corporate treasurers appear well convinced of the de facto 100 percent insurance coverage for large banks. The treasurers surveyed indicated a belief that as long as a bank was fairly large there was little need to evaluate risk. Another reason treasurers cited for not looking at risk, especially with their primary bank, was that their companies are rarely in a net depositor position.

The majority of the individual and small business depositors interviewed exhibited a general lack of financial expertise to properly analyze a bank's financial condition. Some rely on personal contact with the banker; others rely on newspapers, other news media or rumor. What is not known is the effort they would make to become familiar with bank analysis techniques as a result of a risk-sharing plan.

Demand Deposits

Another category where increased protection might be appropriate is demand deposits. Based on the survey estimate, uninsured demand deposits total about $125 billion, approximately 30 percent of the total uninsured. These figures are somewhat misleading; studies in closed banks indicate that as much as three-fourths of the business demand deposits are protected by loan offsets. This appears consistent with the results of the survey in which corporate treasurers stated they were rarely in a net depositor position.

Some corporate treasurers claimed that transaction accounts such as payroll and lock-box accounts cannot be controlled on a daily basis and that periodically they are substantially above insurance levels. They argued that certain bank relationships are necessary to conduct business and that transaction accounts should be viewed differently than CDs. These arguments have some merit particularly in view of the role transaction accounts play in the flow of commerce. The problem is that isolating these accounts for additional protection would be difficult now, and ultimately may become impossible.

INCREASING SMALL DEPOSITOR PROTECTION: OPTIONS AND POTENTIAL PROBLEMS

Several alternative options have been considered for increasing insurance protection for those uninsured depositors identified either as unsophisticated or as noninvestors. While each alternative has desirable benefits, the implementation of some options is hampered by the inability to isolate those accounts where protection may be appropriate and by the potential for increased deposit brokering activity. Outlined below are three of the options considered along with a discussion of deposit brokering activity.

Full Coverage of Transaction Accounts

There are arguments supporting full coverage for transaction (demand) accounts. Full coverage is consistent with the stability and protection objectives of deposit insurance and would not substantially increase exposure to the FDIC insurance fund. While total uninsured demand deposits stand at about $125 billion, the vast majority is held in business accounts with up to three-fourths offset by loans. The net exposure is probably closer to $50 billion and includes lock-box and payroll accounts which, as noted previously, could be considered for increased insurance coverage.

Demand accounts are least like investments and the owners should perhaps not be expected to exert the discipline of investors. Full coverage would also facilitate a less disruptive payoff or a much easier transfer to an assuming bank. Also, with full insurance protection, demand depositors would be less likely to exacerbate a situation by quickly withdrawing their funds or increasing loan balances. This would give a troubled bank more time to work out its problems.

The major, and probably fatal, drawback to this alternative is the previously mentioned blurring of deposit identification. As deregulation progresses, differentiation between accounts will likely depend on the Federal Reserve Board's definition of a transaction account. At present, transaction and nontransaction accounts are distinguished by the number of permissible monthly transactions. Nontransaction accounts are subject to much lower reserve requirements than transaction accounts. So long as a substantial difference is maintained and interest is not earned on reserve balances, it would be expensive for a bank to encourage any shifting of funds from nontransaction to transaction accounts in order to receive full insurance protection. A bank would incur higher costs in the form of rates paid and would be subject to a substantial increase in reserve requirements.

It is uncertain that the definition of transaction accounts will remain the same, that the present differential in reserve requirements between transaction and nontransaction accounts will remain large, or that the Federal Reserve will not begin paying interest on reserve balances. The result of change would be that all depositors would opt for fully-insured transaction accounts, thwarting the discipline being sought. Given these uncertainties, this option is not recommended.

Increased Protection for IRA and Keogh Accounts

These accounts clearly fit the criteria of a small depositor and can easily be identified. Their present volume is minimal, but the accounts can be expected to reach present insurance limits quickly, particularly if allowable contributions are increased. Any market discipline provided by this group probably would not be based on sound financial analysis and therefore is not the type of discipline the FDIC is seeking. Raising the limits for these accounts could minimize uncertainty for this group and any concomitant destabilizing effects on the industry.

Risk-sharing for All Depositors

This alternative is discussed in Chapter III; however, a few points need to be made with regard to the depositor whose banking choices are limited or who cannot precisely control day-to-day balances. Risk-sharing would treat all depositors alike, eliminating the identification problem. It should increase market discipline because it would eliminate full protection where it now exists while at the same time increasing the basic insurance protection for all depositors in a payoff. However, because the proposal does treat all depositors alike, some could argue that those with noninvestment transaction accounts bear a disproportionate burden.

Brokering Insured Deposits

Advances in computer technology have greatly increased the potential role of brokers for marketing deposits to maximize yields and insurance coverage. Brokers can combine the accounts of many small depositors, i.e., accounts of less than $100,000, and place them in $100,000 blocks in banks at high yields. Further, brokers can take the funds of large depositors and distribute them among different insured institutions in amounts of $100,000 or less; thus, providing full insurance coverage.

There is a role for brokers in the intermediary process, but transactions designed solely to allow depositors to earn high yields (in many cases in problem banks) yet pass all risk to the insurance fund are clearly inappropriate. Such activity has the real potential to undermine efforts to increase market discipline.

It is not clear at this point how extensive broker activity might become. There are certain market limitations and mechanical constraints on the total volume of large funds which could be fully insured by these programs. The level of bank demand for brokered deposits is one constraint. Additionally, there are limitations on how easily very large amounts could be divided so as to provide the depositor with the degree of liquidity and flexibility desired. Nevertheless, there is concern that many institutions are being tempted to use insured brokered deposits to fund speculative activities.

To resolve this, several alternatives are being considered that would restrict the degree to which insured brokered funds can be made available to unsafe institutions. Until this problem is solved, any increase in the present $100,000 insurance limit would encourage more broker activity, significantly increase exposure to the insurance fund, and impede market discipline.

APPENDIX G

STATE DEPOSIT INSURANCE PROGRAMS

SUMMARY

Fourteen states operated bank obligation insurance programs at various times prior to the adoption of Federal deposit insurance. The purposes of the early plans were twofold: (1) to protect communities from disruptions of the money supply resulting from bank failures; and (2) to protect individual depositors and noteholders against losses. In spite of the relative sucess enjoyed by some of the programs, all had ceased operations by early 1930.

Following the adoption of Federal deposit insurance, efforts were renewed at the state-level to establish separate insurance programs. At the present time, there exist 30 active state deposit insurance programs. Organizers of these programs have been motivated by philosophical considerations, economic incentives, and regulatory and supervisory considerations. The latter includes a desire to avoid Federal deposit interest rate ceilings.

An examination of the various defunct state programs indicates that the ability of such programs to succeed, all other things being equal, depends on several key factors: the quality of the supervision over the insured institutions; the adequacy of the insurance fund; the liquidity of the fund's resources and its access to other funding sources; and the diversification of the insurer's risks. Lessons learned from the past and present suggest that certain of the programs currently in operation are financially viable, based on their capitalization levels and other criteria, but some others could encounter financial difficulties because of undercapitalization and/or inadequate contingent funding sources.

This study examines state deposit insurance programs. In the first section the state insurance programs which operated prior to the adoption of Federal deposit insurance are summarized. The initial discussion concerns commercial bank deposit insurance programs, since thrift insurance at the state-level did not develop until the 1930s. In the second section the principal state insurance programs established after 1930 that are currently in operation are examined. The last section addresses a number of issues raised with respect to state deposit insurance programs.

INSURANCE OF BANK OBLIGATIONS, 1829 - 1866

In 1829, New York became the first state to adopt an insurance program designed to minimize the economic disruptions caused by bank failures. During the next 30 years five additional states followed suit: Vermont, Indiana, Michigan, Ohio and Iowa. Despite their individual differences, the purposes of the six plans were similar: to protect communities from disruptions of the money supply resulting from bank failures and to protect individual depositors and noteholders against losses.

In striving to meet these goals, the states employed one of three approaches. New York, Vermont and Michigan each established an insurance fund. Indiana, on the other hand, made no provision for an insurance fund; instead, all participating banks were required to mutually guarantee the liabilities of a failed bank. The insurance programs adopted by Ohio and Iowa, in turn, were hybrids of the two approaches described above. While participating banks were bound together by a mutual guaranty provision, an insurance fund was available to reimburse the former after creditors of a failed bank had been paid. Table A1 summarizes the principal provisions of the six programs which operated between 1829 and 1866.

Coverage

In the first four programs adopted, insurance coverage primarily extended to circulating notes and deposits. In New York, coverage was later restricted to circulating notes. In the case of Ohio and Iowa, insurance coverage from the outset only extended to circulating notes. However, none of the six programs placed a dollar limit on the amount of insurance provided an individual bank creditor.

The extension of insurance coverage to banknotes in all of the six programs reflects the importance of banknotes as a circulating medium during the period under discussion. Because it was common practice for banks to raise funds by issuing banknotes, fully one-half of the circulating medium prior to 1860 consisted of banknotes. In those states which limited insurance coverage to banknotes, the belief was that banks affected the circulating medium only through the issuance of banknotes. Additionally, it was believed that depositors could select their banks, whereas noteholders had considerably less discretion and thus were in greater need of protection.[1]

Membership

The original intent to include all banks in the individual state insurance programs gradually was thwarted after the appearance of the "free banking" movement in the 1830s.[2] The movement produced an alternative for insurance of banknotes which permitted a bank to post bonds and mortgages with state officials in an amount equal to its outstanding banknotes. Banks taking advantage of this alternative were excluded from insurance except in Michigan. As the number of "free banks" increased, participation in state insurance programs declined. Table G2 shows the maximum number of insured banks in each of the six states and the obligations insured at such times.

---

[1] Annual Report of the Federal Deposit Insurance Corporation for 1952, p. 61.

[2] The "free banking" movement developed in response to the void created by the closing of the Second Bank of the United States in 1836. To fill this void, many states enacted free banking laws designed to both ease entry restrictions and protect the value of the currency system.

Methods Used to Protect Creditors of Banks in Financial Difficulty

Ad hoc measures frequently were taken in some of the six states to protect creditors of banks in financial difficulty. Faced with the possible insolvency of several banks in 1837, New York State's Comptroller began redeeming their notes from the insurance fund. This action prevented the banks from failing and they eventually were able to reimburse the insurance fund. In 1842, New York faced a more serious crisis after the failure of 11 participating banks within a three-year period threatened the solvency of the insurance fund. The legislature authorized the State Comptroller to sell bonds sufficient to meet all claims against the insurance fund. The bonds were later redeemed from subsequent payments into the fund by participating banks.

Other states similarly grappled with the question of whether to assist or close a distressed bank. On several occasions, authorities in Ohio kept a number of distressed banks from closing by levying special assessments upon healthy participating banks. Indiana and Iowa also granted financial assistance to distressed banks.

Method of Paying Creditors of Failed Banks

Only the programs of Ohio and Iowa provided for immediate payment of insured obligations. Necessary funds were made available in those two states through special assessments levied on the sound participating banks. Creditors in New York, Vermont and Michigan were not paid until the liquidation of a failed bank had been completed. Indiana's program provided that creditors were to be paid within one year after a bank failed from liquidation proceeds and stockholder contributions. If the funds from these two sources were insufficient to cover the insured obligations, the other insured banks made up the deficiency in return for the remaining assets of the failed bank.

Assessments and the Insurance Funds

Data on assessment rates and adequacy of the insurance funds states are shown in Table G3. Assessments were levied on capital stock or insured obligations.

The average ratios of the insurance funds to total and to insured obligations varied considerably from state to state. Michigan had the lowest average ratio on both counts. However, in those states with higher average ratios, most of the income earned from investment of the insurance funds was proportionally returned to the participating banks.

At the time of their closings, the insurance programs of Vermont and Michigan were deficient by $22,000 and $1.2 million, respectively. (Vermont's assessment rate was 1/5th of one percent per annum; the rate in Michigan was 1/10th of one percent.) The modest balance remaining in New York's fund was turned over to the State Treasurer; in Ohio and Iowa fund balances were rebated to the participating banks.

Bank Supervision

Bank supervision was an essential element of the insurance programs which operated prior to 1866. The function of supervision was essentially twofold: (1) to reduce the potential risk exposure of the various insurance programs; and (2) to provide some measure of assurance to well-managed banks that unsound banking practices of badly-managed banks would not go completely unchecked.[3] Table G4 summarizes the principal provisions relating to bank supervision in the six insurance states.

Better supervision of banks was achieved by the programs with mutual guaranty than by the simple insurance fund programs.[4] Under the former, supervisory officials were largely selected by, and accountable to, the participating banks. Consequently, the officials were given wide latitude by the participating banks to check unsound banking practices because the latter knew that the cost of lax supervision ultimately would be borne by them.

Demise of the Insurance Programs

Michigan's insurance program was the first to fail. Although the official end of bank obligation insurance in Michigan occurred in late 1842, the state insurance fund was insolvent for all practical purposes as of year-end 1838. Michigan's difficulties largely stemmed from the fact that the first bank failures occurred before a sufficient fund had been accumulated. The fate of the remaining five programs was sealed in 1865 when Congress levied a prohibitive tax upon state banknotes. In order to escape the tax, many state banks converted to national charters. Before long, state banknotes were driven from circulation.

STATE INSURANCE OF BANK DEPOSITS, 1908 - 1930

As long as national banknotes, which were fully guaranteed by the United States Treasury, retained their relative importance in the circulating medium, the need for bank obligation insurance lost its urgency. However, as bank deposits overtook and then eclipsed national banknotes in importance as a circulating medium, efforts were renewed to provide for deposit insurance. Various proposals to that effect were introduced both in Congress and in state legislatures. As was the case earlier, proponents stressed the need to protect the money supply against disruptions caused by bank failures.

---

[3] Carter H. Golembe and Clark Warburton, Insurance of Bank Obligations in Six States, (Washington, D.C.: Federal Deposit Insurance Corporation, 1958), pp. I-9 - I-10.

[4] Annual Report of the Federal Deposit Insurance Corporation for 1953, p. 59.

Between 1907 and 1917, eight states adopted deposit insurance programs. Seven of the eight states were located west of the Mississippi in predominately agricultural areas. Table G5 summarizes the principal provisions of the eight programs.

Coverage

Insurance coverage in the eight states only extended to deposits. Although the insurance programs were commonly known as "deposit guaranty" programs, the guaranty was that of a fund derived from assessments on the participating banks. In no instance did the state guarantee the deposits.

None of the states, except Kansas for a brief period, placed an insurance limit on the size of account or amount of deposits owned by a depositor. However, some restrictions were applied to various classes of deposits. Whereas demand deposits generally were covered in all eight states, protection of time and savings deposits varied somewhat. In Texas, for example, the guaranty was limited to noninterest-bearing deposits. In Washington, the guaranty law did not apply to mutual savings bank deposits. In all cases, interest rate restrictions were applied to insured time and savings deposits. Deposits bearing interest which exceeded permissible limits were barred from guaranty.

Membership

In Kansas and Washington, membership in the insurance program was voluntary; in the remaining six states membership was compulsory. None of the eight insurance programs included national banks. Although the law in five states authorized their participation, a ruling by the Comptroller of the Currency in 1908 forbidding national banks to join state insurance programs rendered such provisions inoperative.

Table G6 shows the maximum number of banks participating in each of the insurance programs and the amount of deposits in insured banks at the time of such participation.

Methods of Paying Depositors of Failed Banks

In two states, Kansas and Mississippi, the depositors of a failed bank received interest-bearing certificates. Dividends on these certificates were paid from liquidation proceeds. Upon final liquidation of all assets, the balance due on the certificates was paid from the insurance fund. Mississippi law stipulated that if the insurance fund was insufficient to pay the depositors, they were to be paid pro rata, and the remainder paid from subsequent assessments.

In the remaining six states, the deposit insurance law provided for immediate cash reimbursement by the fund, either in full or to whatever extent was practicable. In most instances, provision was also made for the issuance of certificates of indebtedness in the event there was insufficient money in the fund.

Role of Bank Supervision

A majority of the eight states granted requisite officials sufficient authority and power to regulate banks under their jurisdiction.[5] For the most part, banking officials could enforce capital requirements and issue cease-and-desist orders to bring about corrections of various infractions. In four of the states, supervisory authorities could order the removal from office of bank officials for just cause. With regard to frequency of bank examinations, semiannual examinations were the norm.

Despite the various powers granted to banking authorities, supervision often proved to be lax. Because of understaffing and insufficient funding, examiner workloads frequently were untenable. In Kansas, for example, each examiner was scheduled to perform 200 bank examinations annually. In other instances, banking authorities were thwarted when they tried to enforce laws on the books. Texas authorities, for example, rarely were able to secure convictions in local courts against dishonest bank officers. In a few cases state banking authorities were the root of the problem. Successive banking commissioners in Kansas watered down existing supervisory powers. Oklahoma provided the worst example in that the bank commissioner's office itself became corrupt after 1919.

Assessments

All of the insurance programs derived the bulk of their income from assessments. Both regular and special assessments were based on total deposits. The assessments collected ranged from an amount equivalent to an average annual rate of about 1/8th of one percent (Kansas) to about 2/3rd of one percent (Texas). Some states permitted participating banks to retain their insurance assessments in the form of deposits, subject to withdrawal by order of the administrative agency of the fund. Other states provided for the physical collection of assessments by the administrative agency of the insurance fund or the state treasurer.

Adequacy and Termination of Insurance Funds

The economic events of the 1920s showed that all but one of the state insurance funds were inadequate. The depression of 1921 and the severe agricultural problems which persisted throughout much of the decade resulted in numerous bank failures. The resultant claims on the various insurance funds generally exceeded accumulated assessment receipts. The insured deposits in the eight states which were never paid from any source ranged from none in Texas to 70 percent in South Dakota.

---

[5] An in-depth discussion of the role of bank supervision appears in Clark Warburton's study, Deposit Insurance in Eight States During the Period 1908-1930 (Washington, D.C.: Federal Deposit Insurance Corporation, 1959).

The first fund to cease operations was that of Washington in 1921. Even the Texas fund became insolvent after most of the participating banks withdrew. By early 1930 all of the funds had ceased operations.

STATE-LEVEL DEPOSIT INSURANCE DEVELOPMENTS, 1930 TO THE PRESENT

The collapse of the state deposit insurance programs, coupled with related business and economic developments during the early 1930s, resulted in renewed efforts to provide for nationwide insurance of bank deposits. Those efforts culminated in the passage of the Banking Act of 1933 and the creation of the FDIC. Under the Act, membership in the FDIC was mandatory for national banks and optional for state-chartered banks and mutual savings banks. Because many state-chartered banks soon joined the FDIC, the need to establish comparable state programs was largely obviated. Since 1933, only one state-level program to insure solely commercial bank deposits has been established.[6]

In contrast to the willingness of state-chartered commercial banks to join the FDIC, mutual savings banks generally were reluctant to do so. Many savings bankers felt that the rates to be charged for deposit insurance were too high, particularly in view of their industry's historically low failure rate.[7] At the same time, however, they recognized that the lack of deposit insurance could prove to be a competitive liability. Consequently, while some savings banks joined the FDIC, others sought to establish state-level programs. The Massachusetts Deposit Insurance Fund, created in 1934, was followed by the creation of a similar program in New York.

Efforts to establish other such programs lost their impetus after FDIC insurance rates were reduced in 1937. By the early 1940s, many mutual savings banks had joined the FDIC. Those enrolled in New York's Savings Banks Mutual Fund voted to liquidate in 1943 and then joined the FDIC. Their decision was prompted by fears that the state fund would prove inadequate in the event of a real emergency.[8] While Connecticut established a savings bank insurance

---

6/The Pennsylvania Deposit Insurance Corporation, which currently insures four state-chartered commercial banks, was incorporated in 1980. A few state-level programs, such as the Rhode Island Share & Deposit Indemnity Corporation, insure both commercial banks and other types of financial institutions.

7/Weldon Welfling, Mutual Savings Banks (Cleveland, Ohio: Case Western Reserve University Press, 1968), pp. 95-96.

8/Adolph A. Berle, Jr., The Bank that Banks Built (New York: Harper & Brothers, 1959), pp. 71-72.

fund in 1943, the same year the New York fund ended operations, the Connecticut fund went out of existence in 1960 and its members joined the FDIC. The Massachusetts program, which is discussed more fully later, constitutes the only existing state-level deposit insurance program for mutual savings banks.

Insurance for savings and loan associations ("S&Ls") began at both the Federal and state-levels in 1934. At the Federal level, the Federal Savings and Loan Insurance Corporation ("FSLIC") was created under the Federal Housing Act. At the state-level, the Massachusetts Cooperative Central Bank, a liquidity fund for its member savings and loan associations, was granted deposit insurance authority in 1934. Subsequently, separate programs were established in the following states: Ohio (1956), Maryland (1962), Mississippi (1962), North Carolina (1967), and Pennsylvania (1979).[9] While a variety of factors prompted the creation of these later state programs, a principal motivating force was the desire to escape the burdens imposed by Federal regulations, particularly interest rate ceilings. This issue is addressed in the final section of this appendix.

Credit union interest in share insurance manifested itself in 1940 in the enactment of legislation authorizing creation of a share insurance fund in New York.[10] However, the legislation was never implemented. Although a credit union guaranty corporation operated in Illinois between 1956 and 1962, a sustainable program did not come into being until the establishment of the Massachusetts Credit Union Share Insurance Corporation in 1961. From 1967 to the present, 17 additional share insurance programs for state-chartered credit unions have been organized.[11]

Insurance of industrial banks at the state-level is a relatively recent development. The first such program was begun in California in 1971. Since then, insurance programs have been established in five other states, all of which are located west of the Mississippi.

Currently, there exist 30 state-level insurance programs for depositors. The largest number of these programs (18) exist for credit unions. In addition,

---

9/Mississippi's program went bankrupt in 1976 after the failure of one of its members precipitated runs on other state insured S&Ls. A discussion of the Mississippi program appears in Gary Leff and James W. Park's article, "The Mississippi Deposit Insurance Crisis," Bankers Magazine, Summer 1977, pp. 74-80.

10/Donald J. Schaefer, "A Brief Deposit Insurance History," 1982 State Share Insurance Yearbook (Atlanta, Georgia: International Share and Deposit Guaranty Association, 1982), pp. 10-11.

11/1970 marked the creation of a Federal share insurance program for credit unions. Membership in the National Credit Union Share Insurance Fund ("NCUSIF") is mandatory for Federal credit unions and optional for state-chartered credit unions.

six programs insure depositors of industrial banks, four insure savings and loan associations, one program insures cooperative banks, one insures mutual savings banks, and one program insures solely commercial bank deposits. (One of these insurers, in North Carolina, insures both S&Ls and credit unions.) The number of insurance funds has been growing at a fast pace in recent years, with the California, Nebraska, and Pennsylvania programs having been created during the past five years. In the last two years, Pennsylvania has initiated separate insurance programs for savings and loan associations and previously uninsured commercial banks.

Table G7 shows the principal characteristics of the insurance programs for institutions other than credit unions. Table G8 compares the share insurance programs for credit unions in the U.S., Puerto Rico and Canada, all of which are members of the International Share and Deposit Guaranty Association, an affiliate of the Credit Union National Association. The financial aspects of state-level insurance programs are discussed below.

FINANCIAL CHARACTERISTICS OF STATE PROGRAMS

Resources

Each plan has its own means of acquiring and maintaining its insurance fund. The primary source of funds is the periodic, chiefly annual, premium. The second is the initial membership deposit, which is occasionally adjusted by assessments to maintain a certain predetermined ratio of insurance funds to insured deposits. The third source of funds is the earnings of the insurer, which, if not rebated or distributed in some form to the member institutions, represents an implicit premium.

The most clearly evident relationship regarding assessment costs is that they vary inversely with the size of the insurance funds. The least expensive insurance programs are the three national ones (FDIC, FSLIC and NCUSIF) and the two large ones in Massachusetts. Conversely, the smaller the fund, the greater the insurance cost burden. For example, the Pennsylvania Deposit Insurance Corporation, which is the smallest fund, levies a relatively large annual premium equal to one-sixth of one percent of deposits.

Some funds require that relatively high membership deposit levels be kept in lieu of, or in addition to, annual premiums. For example, North Carolina requires 1.25 percent, while Ohio and the Pennsylvania Savings Association Insurance Corporation both require two percent. Most of the credit union insurers require one percent. The opportunity cost of these membership deposits can be burdensome since the insured institution earns no income on these funds. For instance, if a member institution is required to maintain a one percent membership deposit, the opportunity cost can exceed the annual premium if interest rates exceed eight percent.

Liquidity Provisions

In addition to evaluating the explicit resources of an insurance fund (its size and assessment potential), it is necessary to examine its ability to meet calls on its resources without significant risk of market loss. Most of the funds are quite liquid, having investment portfolios with short maturities or arrangements for back-up lines of credit. These sources of liquidity for the state insurance funds are:

1. Short-Term Investments: Most of the state insurance funds are fairly liquid. For instance, Massachusetts' Mutual Savings Central Fund's Deposit Insurance Fund maintains a portfolio limited to U.S. Treasury securities and government-agency obligations, 38 percent of which matures within one year and 69 percent within two years. The Liquidity Fund of MSCF, which is used to meet the borrowing needs of its members, is 90 percent invested in securities maturing within two years. The Central Reserve Fund of the Maryland Savings-Share Insurance Corporation is highly liquid with about 70 percent of its investments, all of which are in Treasury securities and government-agency obligations, having maturities under one year. The Ohio Deposit Guarantee Fund maintains an investment portfolio with more than 75 percent of its assets in Treasury and agency securities with maturities under two years. The Cooperative Central Bank of Massachusetts has, excluding those securities it purchased to facilitate mergers, a portfolio of Treasury and Agency securities, 80 percent of which have maturities of less than two years. Similarly, the Industrial Bank Savings Guaranty Corporation of Colorado is almost entirely invested in assets with maturities of less than two years. The Pennsylvania Deposit Insurance Corporation has its entire investment portfolio invested in certificates of deposit issued by four large banks, 70 percent of which matures within six months.

2. Additional Funding Sources: Most insurers have guaranteed themselves a borrowing back-up in the event the liquidity provided by their short-term assets becomes strained. Typical is that of the Maryland Savings-Share Insurance Corporation, which has established a guaranteed line of credit of $98 million with several large commercial banks to provide immediate liquidity. These lines of credit are costly to the insurers because of the related commitment fees and compensating balance requirements. However, the insurers regard these lines as the equivalent of an inexpensive reinsurance program.

   While a guaranteed line of credit is not technically reinsurance, it is considered to be the equivalent by many state insurers. The credit line keeps the fund in business after unusually large assistance payments have been made. Of course, the funds advanced must be repaid, but these borrowings would generally be collateralized by assets acquired by the insurer from a member institution as part of an assistance program. These assets would eventually be liquidated and the line of credit paid off. Similarly, several insurance funds have used reinsurance as an alternative to having back-up lines of credit.

3. Reinsurance: Broadly defined, reinsurance is any program that shifts some or all of the risk from a particular insurer to another insuring entity. Some state insurance funds engage in reinsurance of various types. Some

of the state-level insurance funds have taken out private reinsurance policies. Five of the state-level credit union insurers have done so. (See Table G8). Coverage ranges from $2 million to $14 million. One of these, the North Carolina Savings Guaranty Corporation ("NCSGC") also insures S&Ls. NCSGC has reinsurance coverage of $14 million, with an $8 million deductible. Apparently the $14 million is the largest anticipated individual loss to which NCSGC estimates it is exposed. In addition to the reinsurance policy, NCSGC maintains a $50 million line of credit with two major commercial banks for liquidity purposes. It should be noted that NCSGC is slightly above average in membership expenses and premiums.

Massachusetts' Mutual Savings Central Fund, which insures the total deposits of its member mutual savings banks, receives reinsurance-type benefits from the FDIC to the extent that some of its savings banks are members of both programs. In such instances, the FDIC provides insurance on deposits up to $100,000, and MSCF covers balances in accounts larger than $100,000.

Based on discussions with Mr. Charles C. Hogg, II, Executive Vice President and Chief Operating Officer of the Maryland Savings-Share Insurance Corporation, it appears that some comparison snopping has been done and outright reinsurance seems to be much more expensive than the alternative of establishing large lines of credit. Consequently, reinsurance programs are not prevalent. Presently, the only company offering reinsurance of deposit insurance is the Insurance Company of North America ("INA").

Handling Failing Institutions

State-level insurers have a distinct mode of operation in resolving problem situations. Insofar as state-level insurers are closely tied to the state financial institution supervisor, the former have timely access to examination reports. Thus, timely resolution of problems is the usual outcome.

The goal of assistance is to eliminate by merger a nonviable institution as soon as possible so as to minimize the amount of required assistance and, more importantly, to completely eliminate the possibility of a payoff of depositors. Assistance usually consists of low interest loans to the resultant institution. Occasionally, funds will be granted outright or granted in exchange for a failing institution's low-yielding or heavily depreciated portfolio (see examples in Table A7).

ISSUES RELATED TO STATE DEPOSIT INSURANCE PROGRAMS

The preceding examination of past and present state-level deposit insurance programs raises two questions. First, what has been the role of state-level deposit insurance programs? Second, are the existing programs financially viable? In addressing these, it is important to bear in mind the purposes of deposit insurance: (1) to minimize the economic disruptions caused by failures of financial institutions; and (2) to protect depositors against losses.

Function and Role of State-level Deposit Insurance Programs

Since the early 1930s, organizers of state-level programs have been motivated by philosophical considerations, economic incentives, and regulatory and supervisory policy considerations. The latter includes a desire to avoid Federal deposit interest rate ceilings (Regulation Q). The function and role of existing state-level deposit insurance programs can be assessed in the context of these motivations.

The desire to operate free from Federal control has been, and continues to be, a major force underlying the establishment and existence of state-level deposit insurance programs. In many cases, this reflects a deep-seated aversion to Federal intervention in private business decisionmaking and a concurrent strong belief in states' rights. In other cases, it represents a desire to preserve a dual Federal-state system of financial intermediation and regulation. In some instances, the preference for state-level insurance has been financially motivated.

Economic factors have played an equally important role with respect to the establishment of state-level programs over the past 50 years. For example, organizers of the deposit insurance program for mutual savings banks in Massachusetts desired to offer member institutions lower assessment rates than those charged by the FDIC in the mid-1930s. Subsequently, state-level deposit insurers have sought to offer a realistic alternative to Federal insurance, based on premium cost.

Cost considerations apart from premium pricing have also enabled state-level programs to attract members. For example, one small Maryland savings and loan association several years ago switched to MSSIC because it preferred to keep its accounts on a cash basis and could not afford to simultaneously satisfy Federal accrual accounting requirements. In other instances, institutions have joined state-level programs in order to avoid the burdens and costs imposed by Federal paperwork requirements.

The state-level programs also have offered an alternative to the Federal insurers with respect to various regulatory and supervisory practices. An institution that is state-chartered and not federally insured can avoid Federal supervision and regulation. This may be viewed as beneficial if state laws are less restrictive than Federal statutes and/or state supervision is more lax than at the Federal level. In addition, many state-level insurers perform a booster role by actively promoting the interests of member institutions.

Over the years, state-level deposit insurance programs have provided an important mechanism by which member institutions (except those located in Massachusetts) have been able to circumvent interest rate ceilings imposed by Federal authorities. Federal authority to regulate interest rates (Regulation Q) dates back to the Banking Act of 1933. Under the Interest Rate Adjustment Act of 1966, thrift institutions were brought under Regulation Q. The Act gave the FDIC power to regulate interest rates paid by federally insured mutual savings banks; comparable power over federally insured savings and loan associations was given to the Federal Home Loan Bank Board ("FHLBB").[12]

As interest rates subsequently rose above Regulation Q ceilings, institutions desired to circumvent those ceilings in order to gain an edge over their competitors. By obtaining state insurance (except in Massachusetts), institutions could avoid Regulation Q ceilings altogether.

The strong motivation to escape the strictures of Regulation Q has contributed to the past growth of many of the state-level deposit insurance programs. However, as a result of the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980, the interest rate advantage afforded by membership in state-level deposit insurance programs is rapidly disappearing. After interest rates are fully deregulated by 1986, this advantage will disappear altogether. Although the complete deregulation of interest rates may not cause member institutions to leave the state programs, it could perceptibly slow membership growth in those programs.

Viability of State-level Deposit Insurance Programs

In assessing the viability of state-level deposit insurance programs, historical perspective proves useful. An examination of the various defunct state programs suggests that the ability of such programs to succeed, all other factors being equal, depends on several key factors: the quality of the supervision over the insured institutions; the adequacy of the insurance fund; the liquidity of the fund's resources and its access to other funding sources; and the diversification of the insurer's risks. With respect to the first factor, the research undertaken by Clark Warburton amply documented the role played by bank supervision in the success or failure of the various insurance programs which existed prior to the adoption of Federal deposit insurance. The success enjoyed by the program in Indiana during the 1800s, for example, was due in large part to the high quality of bank supervision that existed in that state.

The ability of a fund to accumulate sufficient reserves before it is required to offer assistance is a second critical factor influencing its financial viability. This has been true historically and remains true today. Of the six insurance programs established between 1829 and 1858, both Vermont and Michigan encountered problems before they were adequately capitalized. Although Vermont's fund subsequently recovered, Michigan's collapsed under the strain. In the latter instance, all but one of the participating banks in the program failed soon after the fund was established. More recently, Mississippi's insurance program collapsed when its fund proved insufficient to handle the failure of Bankers Trust Savings and Loan Association of Jackson and subsequent runs on other member S&Ls.

---

[12] The Act also applied to state insured thrift institutions in Massachusetts.

Lessons learned from the past and the present suggest that the programs to insure thrifts in Massachusetts, Maryland, and Ohio, and the industrial bank fund in Colorado are financially viable, based on their capitalization levels, although it is not clear that any of them could have survived the turmoil of the 1980-82 "thrift crisis" had the Federal deposit insurance funds not been available to maintain basic stability in the financial system. The Massachusetts Cooperative Central Fund has the highest ratio of insurance funds to deposits (3.52 percent), followed by MSSIC (3.42 percent), the Ohio Deposit Guarantee Fund (2.72 percent), the Massachusetts Mutual Savings Central Fund (2.56 percent), and the Industrial Bank Savings Guaranty Corporation (2.28 percent). These funds are relatively long-lived, thus having had sufficient time to accumulate reserves.

In contrast, recently established programs, particularly those that insure a limited number of institutions, would be hard pressed to handle potential problems in the near term. For example, the Utah Industrial Loan Guaranty Corporation and Pennsylvania Deposit Insurance Corporation have insurance funds to insured deposits ratios of 0.27 and 0.32 percent, respectively. Ratios this low, in the absence of other significant sources of funds, warrant concern.

Past history demonstrates the importance of liquidity as a factor affecting an insurance fund's viability. Several of the early state-level commercial bank deposit programs encountered problems because they lacked liquidity. New York's fund was provided with borrowing power about 15 years subsequent to its establishment, after insurance operations had temporarily broken down during the 1840s. The collapse of Mississippi's program provides a more recent example of what can occur when a fund is insufficient and access to liquidity sources is nonexistent or inadequate.

Currently, most funds have secured guaranteed lines of credit as a source of liquidity. The most secure borrowing power is that of the Federal insurers, FDIC, FSLIC, and NCUSIF, all of which can borrow from the U.S. Treasury. The Thrift Guaranty Corporation may borrow from the State of Hawaii. All other funds are constrained to borrowing from nongovernmental sources. Most have secured guaranteed lines of credit from commercial banks. Typically, the more established funds have the most significant borrowing lines. The Maryland Savings-Share Insurance Corporation has a $98 million line of credit, the North Carolina Savings Guaranty Corporation has a line for $50 million, and the Massachusetts Cooperative Central Fund has a line for $53 million.

Reinsurance agreements constitute another source of liquidity. The Federal funds are implicitly reinsured by the full faith and credit of the U.S. government. Only one insurer has a policy from a private carrier: the North Carolina Savings Guaranty Corporation has a reinsurance policy with INA. The other four credit union insurance funds, which are reinsured by Aetna, will soon lose their reinsurance, if they have not already done so, since Aetna has left the deposit insurance field. However, the International Share and Deposit Guaranty Association is attempting to develop its own reinsurance affiliate.

An overall assessment of the viability of the current state-level programs suggests that some of the funds could encounter financial difficulties because of undercapitalization and/or inadequate lines of credit.

A final factor influencing the success of state-level programs is the diversity of the institutions in the insured population. Diversification of risk is the basic means by which an insurer seeks to limit potential exposures to its insurance fund. State-level programs may lack this diversification in any one of three respects.

A state insurance fund covers only institutions located within a relatively small geographic area. The economy of a state would be more likely to experience adverse conditions such as high unemployment over an extended period of time than would the economy of the nation as a whole. Loan credit quality throughout a single state or a major part of one could deteriorate, leaving a state-level insurance program with more distressed institutions than it could effectively deal with at one time.

Certain depository institutions suffer from limitations on their product lines which may restrict the types of loans or investments they are permitted to make. Their asset portfolios would tend to be less diversified and they would be less able to restructure their assets in response to a changing economic environment than institutions that do not operate under such restrictions. A program that insures institutions with narrow investment powers could find a large number in need of assistance simultaneously.

Finally, while the Federal deposit insurance programs insure thousands of banks, S&Ls, and credit unions, the membership bases of the state-level programs run from four banks in Pennsylvania to 601 credit unions in Wisconsin (see tables G7 and G8). The smaller the number of institutions a fund insures, the greater the impact on future assessment income and the fund's resources the withdrawal from membership of or failure of a single member institution will have.

Federal Government's Stance toward State-level Deposit Insurance Programs

In the past, the Federal government has not provided any assistance to state-level deposit insurance programs. When Mississippi's insurance fund was close to collapse and the state could not legally guarantee depositors' funds, the Governor attempted to obtain Federal guarantees similar to aid for natural disasters.[13/] After such guarantees could not be secured, the governor declared a banking holiday for all state-chartered S&Ls and called the legislature into extraordinary session to remedy the crisis. The legislature subsequently provided for a court appointed conservator to help associations to reopen and required the latter to obtain FSLIC insurance or its equivalent by a certain date.

[13/] Leff and Park, op. cit., p. 74.

Some observers have asserted that the Federal Reserve Board's ("FRB") actions in arranging a merger in 1982 involving the financially-troubled Scioto Savings Association, a state-insured S&L, were necessary to prop up the Ohio Deposit Guarantee Fund. Strong evidence exists, however, that the Ohio Fund had the necessary resources to liquidate Scioto had no merger partner been found. Consequently, the FRB's action in that instance did not constitute assistance to a state-level fund by the Federal Government.

While the Federal government has not assisted a state-level program in the past, there is no assurance that such assistance will not be requested in the future. As noted previously, several of the programs at the present time are financially vulnerable. Because of the possibility that serious problems encountered by a state fund could spill over and cause a loss of confidence in Federally-insured institutions in the state, it is appropriate to consider what forms of assistance could be offered by the Federal government under existing statutes.

As the lender of last resort, the Federal Reserve could open its discount window to a financially-troubled, state-insured institution or, conceivably, lend to a state fund directly. Some state fund officials already have discussed the feasibility of the second option informally with Federal Reserve officials.

Under Title II of the Garn-St Germain Depository Institutions Act of 1982, qualified state-insured institutions may request assistance from the Federal insurers (FDIC and FSLIC). To qualify for assistance an institution must meet certain criteria: (1) have net worth equal to or less than three percent of its assets; (2) have incurred losses during each of the two previous quarters; (3) have not incurred such losses because of mismanagement; (4) have net worth of not less than one half of one percent after the granting of assistance; (5) have investments in residential mortgages and mortgage-backed securities equal to at least 20 percent of its loan portfolio (including mortgage-backed securities); and (6) agree to the conditions set forth by the respective Federal insurer.

In exchange for granting assistance, the Federal insurers must require the relevant state fund which insures the institution receiving aid to meet two conditions. First, the state fund must agree to indemnify the Federal insurer for any losses which the latter may incur as a result of providing assistance. Second, during the period that assistance has been extended, the relevant state fund must maintain member institution assessments at a rate equivalent to that charged by the Federal insurer.

The FDIC does not beleive a proliferation of small, undiversified insurance funds comports with sound public policy. Accordingly, the FDIC is strongly opposed to any form of Federal assistance to a troubled state fund, particularly assistance from the Federal Reserve or the Federal deposit insurance funds, which are supported by reserves and assessments from Federally-insured institutions. Thus, the most appropriate remedy for handling a troubled state insurance fund would be to disband the fund and bring its member institutions under the umbrella of one of the Federal insurance programs, should they desire.

TABLES

Table G-1

Principal Provisions of Bank-Obligation Insurance Programs in Operation 1829 - 1866

State	Period of operation[1]	Obligations insured	Banks participating	Assessments; size of fund	Payment of bank creditors
New York	1829-1866	1829-42, all debts[2] 1842-66, circulating notes[3]	All banks established or rechartered subsequent to passage of act[4]	Annually ½ of 1% of capital stock to maximum of 3%. If fund reduced, annual assessment not to exceed above rate until fund restored to maximum	After completion of liquidation of failed bank
Vermont	1831-1866	All debts[2]	All banks established or rechartered subsequent to passage of act[5]	Annually 3/4 of 1% of capital stock to maximum of 4-1/2%. If fund reduced, annual assessments not to exceed above rate until fund restored to maximum	After completion of liquidation of failed bank
Indiana	1834-1866	All debts[2]	Branch Banks[6]	No specific amount; special assessments as necessary	Within one year after failure, if liquidation proceeds and stockholder contributions insufficient
Michigan	1836-1842	All debts[2]	All banks established or rechartered subsequent to passage of act	Annually ½ of 1% of capital stock to maximum of 3%. If fund reduced annual assessments not to exceed above rate until fund restored to maximum	After completion of liquidation of failed bank
Ohio	1845-1866	Circulating notes	Branch Banks	Single assessment prior to opening of bank: 10% of amount of circulating notes. Thereafter assessments at above rate applicable only to additional circulating notes, if any, issued by bank	Immediately, through special assessments on solvent Branch Banks. Assessments to be repaid from insurance fund, and fund repaid from proceeds of liquidation of assets of failed bank.
Iowa	1858-1865	Circulating notes	Branch Banks	Single assessment prior to opening of bank: 12-½% of amount of circulating notes. Thereafter assessments at above rate applicable only to additional circulating notes, if any, issued by bank	Immediately, through special assessments on solvent Branch Banks. Assessments to be repaid from insurance fund and fund repaid from proceeds of liquidation of assets of failed bank

---

[1] In a number of cases the law was repealed subsequent to the terminal date shown above. In some of the first six States closing dates may have preceded date shown by one year.

[2] Included circulating notes, deposits, and miscellaneous liabilities; excluded capital accounts.

[3] Act of April 12, 1842.

[4] Free Banks, which were authorized in 1838, did not participate in insurance.

[5] Free banks, which were authorized 1851, did not participate in insurance. In 1842 participating banks were authorized under specified conditions to withdrawal from insurance.

[6] Branch Banks were essentially independent banks which possessed their own officers, distributed earnings to their own stockholders, and which collectively constituted the "State Bank" in these States.

Source: Annual Report of the Federal Deposit Insurance Corporation for 1952.

Table G2

Maximum Number of Banks Participating in Insurance Systems, Six States, 1829-1866

State	Year or years during which number of participating banks was at a maximum	Participating banks		Obligations insured at or near time of maximum participation 1/	
		Number	Percent of all banks 2/	Amount (in thousands)	Percent of all such obligations
New York	1840	91	57.2%	$32,346	72.8%
Vermont	1841-48	13	72.2[3]	1,936[3]	69.9
Indiana	1857-64	20[4]	52.6[5]	7,816[5]	78.2
Michigan	1837	47[6]	83.9	1,403[7]	59.0
Ohio	1850	41	71.9	8,407	76.0
Iowa	1864	15	100.0	1,440	100.0

[1] New York, Vermont, Michigan and Indiana, circulating notes plus deposits: Ohio and Iowa, circulating notes only. See note 7 for explanation of Michigan data.

[2] Excludes private banks.

[3] Data as of August 1847.

[4] Branch Banks of Bank of State of Indiana. Branch Banks of State Bank of Indiana, 1834-1856, numbered 13 at maximum, all of which were insured.

[5] Data for November 15, 1862. Deposits include individual and interbank deposits plus certificates of deposit.

[6] Estimated number in operation near end of year.

[7] Circulating notes only (estimated). Deposit information not sufficiently complete for estimation.

Source: Annual Report of the Federal Deposit Insurance Corporation for 1952.

Table G3

Insurance Funds and Assessments, States with Bank-Obligation Insurance Systems, 1829-1866[1]
(Amounts in thousands)

	New York (1829-1866)	Vermont (1831-1866)	Michigan (1836-1842)	Ohio (1845-1866)	Iowa (1858-1865)
Insurance funds:					
Average Size	$192	$19	$0.3	$759	$196
As percent of -					
Average total obligations	0.6%	2.0%	.09%	7.7%	8.4%
Average insured obligations	1.0	2.0	.09	11.5	21.4
Balance or defiiciency at close of system	$13	-$22	-$1,198	$815[2]	$338[2]
Assessments and fund income:					
Assessments and income available for insurance operations:	$3,221	$63	$3	$1,567	$338
Assessments paid[3] ..	3,120	63	3	1,567	338
Interest received[4] .	101	....	....	....	....
Used for insurance operations	3,208	44	....	722[5]	....
Refunded to banks or State[6]	13	19	....	845	338
Assessments necessary to cover insurance costs	$3,208	$66	$1,198	722[5]	....
Equivalent average annual rate of assessments on total obligations:					
Paid	0.24%	0.2%	0.1%	0.8%	1.8%

[1] In Indiana the insurance system was one of mutual guaranty with no fund.

[2] Amount in fund in last year of full operation of insurance system.

[3] Assessments paid and used for insurance operations other than administrative expenses except in Michigan, where amount paid was completely absorbed by such expenses.

[4] In excess of amounts used to pay administrative expses and amounts paid to banks. In Vermont, Ohio, and Iowa such expenses absorbed the whole of investment income.

[5] Total of special assessments used to redeem notes of failed banks or aid operating banks plus estimated amounts secured from assets in insurance funds of failed banks. Recoveries from other assets of such banks by insurance system are not known.

[6] In New York paid into State treasury; in Vermont refunded to six banks withdrawing prior to close of system; in Ohio refunded to one bank withdrawing prior to close of system and to all banks at close of system; in Iowa refunded to all banks at close of system.

Source: Annual Report of the Federal Deposit Insurance Corporation for 1953.

Table G-4

Principle Provisions Relating to Supervision of Banks Participating in Bank-Obligation Insurance Systems, Six States, 1829-1866

State: Period of bank-obligation insurance	Supervisory agency	Bank examination	Condition reports	Enforcement powers of supervisory officials
New York 1829-1866	1829-37. Three Bank Commissioners; one appointed by Governor; two by banks. 1837-43. Three Bank Commissioners appointed by Governor. 1843-51. State Comptroller. 1851-66. Banking Department; superintendent appointed by Governor.	1829-43. Each bank three times per year; additional examinations if requested by three participating banks. 1843-66. Examination only when bank was believe to be insolvent or to have submitted false condition report.	1829-43. Annually to Bank Commissioners. 1843-66. Quarterly to Comptroller; Superintendent of Banking Department. Content expanded.	If bank insolvent or had violated law could apply to court of chancery for injunction against continued operation.
Vermont 1831-1858	1831-37. Three Bank Commissioners; one appointed by legislature; two by banks. 1837-58. One Bank Commissioner appointed by legislature.	Each bank once per year; additional examinations if requested by a stockholder or bank debtor.	Annually to Bank Commissioners.	If bank insolvent or had violated law could apply to court of chancery for injunction against continued operation.
	1834-55. Board of Directors of the State Bank of Indiana; President and four directors appointed by legislature; one director by each Branch Bank.	Each bank twice per year; additional examinations if requested by directors of a bank.	Monthly to Board.	If bank insolvent, had violated law, or was mismanaging its affairs could close bank. Could regulate dividend payments.[1]
Indiana 1834-1865	1856-63. Board of Directors of the Bank of the State of Indiana; four directors appointed by legislature; one director by each Branch Bank; president by Board.			Could establish ratio of loans and discounts to capital for any or all banks between limits 1.25 to 1.00 - 2.50 to 1.00. Loan of deposited funds exempted.
Michigan 1836-1842	1836-37. One Bank Commissioner appointed by Governor. 1837-40. Three Bank Commissioners appointed by Governor. 1840-42. Attorney General.	1836-40. Each bank three times per year; additional examinations if requested by three participating banks. 1840-42. Whenever requested by Governor.	Annually to Bank Commissioners; Attorney General.	If bank insolvent or had violated law could apply to court of chancery for injunction against continued operation.
Ohio 1845-1866	Board of Control of the State Bank of Ohio; one member appointed by each Branch Bank; president by Board from outside its membership.	Left to discretion of Board; policy was to examine each bank once per year.	Quarterly to Board, policy to require monthly reports to Board.	If bank insolvent, had violated law, or any order of Board, could close bank. Could order any bank to reduce its circulation or liabilities to whatever level was deemed safe. Could determine proportion of reserve to be in vault cash.[1]
Iowa 1858-1866	Board of Directors of the State Bank of Iowa; three directors appointed by legislature; one director by each Branch Bank; president by Board.	Left to discretion of Boare; policy was to examine each bank twice per year.	Monthly to Board.	If bank insolvent, had violated law, or any order of Board, could close bank. Could regulate dividend payments. Could order any bank to reduce its circulation or liabilities to whatever level was deemed safe.

[1] Not stipulated in law but assumed by agency.

Source: Carter H. Golembe and Clark Warburton, Insurance of Bank Obligations in Six States, (Washington, D.C.: The Federal Deposit Insurance Corporation, 1958), pp. I-8 - I-9.

Table G-5

Principal Provisions of Deposit Insurance Programs Adopted by Eight States, 1907-1917

State	Deposits insured	Banks participating[1]	Assessment on insured deposits[2]	Payment of depositors
Oklahoma Act of 1908[3] as amended or modified 1909, 1911, 1913	All deposits not otherwise secured and on which rate of interest was within limits specified by law	Compulsory for all State banks and trust companies	Annually 1/5 of 1% until fund equaled 2% of base. If fund reduced, special assessments at same rate annually[4]	In cash by Bank Commission immediately upon taking possession of bank. If fund insufficient, in 6 percent certificates of indebtedness to be paid in order of issue. After 1913 certificates sold at not less than par for purpose of securing cash for depositors
Kansas Act of 1909 as amended or modified 1911, 1921, 1923	All deposits not otherwise secured and on which rate of interest was within limits specified by law	Voluntary for all incorporated State banks. Trust companies and private banks excluded. Banks organized after passage of Act eligible to apply after operating one year	Annually 1/20 of 1% of base less capital and surplus until fund equaled $1 million. If fund reduced below $500,000 special assessment for amount necessary	In interest-bearing certificates of indebtedness, reduced as proceeds of liquidation become available. Deficiency, if any, paid from fund
Nebraska Act of 1909 as amended or modified 1911	All deposits except money deposited on a collateral agreement or condition other than an agreement for length of time to maturity and rate of interest	Compulsory for all incorporated State banks	Semi-annually 1/20 of 1% until fund equaled 1-1/2% of base. If fund reduced below 1% assessment renewed and special assessments if necessary not to exceed 1% of base in any one year	In cash from fund immediately after determination by the court of amount due depositors less cash immediately available to the receiver for such payments
Texas Act of 1909 as amended or modified 1921, 1923	Non-interest-bearing deposits not otherwise secured. Excluded public deposits, secured deposits, certificates of deposit, deposits made for the purpose of converting a loan into a deposit covered by the fund, certificates of deposit converted to non-interest-bearing deposits within 90 days of failure	All State chartered banks required to choose between guaranty fund system or bond security system	Annually ¼ of 1% of base until fund equaled $5 million. If fund reduced below $2 million, or below level of preceding January 1, special assessments not to exceed 2%	In cash immediately, out of cash in failed banks and fund
Mississippi Act of 1914	All deposits not otherwise secured nor bearing interest exceeding 4% per annum	Voluntary until May 15, 1915. Thereafter compulsory for all banks operating under State law including trust companies and savings banks	Annually 1/20 of 1% of "average guaranteed deposits, less capital and surplus until fund approximates $500,000 over and above initial contribution. If fund depleted, special assessments at same rate not to exceed five in any one year	In interest bearing certificates of indebtedness, reduced as proceeds of liquidation become available. Deficiency, if any, paid from fund
South Dakota Act of 1915 as amended or modified 1921	All deposits not otherwise secured. Deposits could not pay interest in excess of 5% unless authorized by depositors guaranty fund commission and in no case, more than 5-½% per annum	Compulsory for all State and private banks	Annually ¼ of 1% until fund equaled 1-½% of base. Resumed whenever fund reduced to 1% of base	In cash immediately from fund. If fund deficient, Commissioner to issue certificates of indebtedness at 5% and not to exceed 7% if sold to secure cash for depositors
North Dakota Act of 1917 as amended or modified 1923	All deposits not otherwise secured and on which interest was within limits specified by law	Compulsory for every corporation in business of receiving deposits or buying and selling exchange except national banks	Annually 1/20 of 1% until fund equaled 2% of base. If fund reduced to 1-½% of base, assessments resumed. Special assessments at same rate at option of Bank Commissioners, not to exceed four per year	In cash from fund after certification of net amounts due depositors. If fund deficient, in certificates of indebtedness
Washington Act of 1917 as amended or modified 1921	Deposits subject to check or other forms of withdrawal and not otherwise secured. Payment of interest at rates higher than authorized by guaranty fund board subjected bank to loss of insurance	Voluntary for all State banks including trust companies but excluding mutual savings banks	Annually 1/10 of 1% until fund equaled 3% of base. If fund reduced, special assessments not to exceed ½ of 1% in any one year	In warrants on fund issued on proof of claim; if fund deficient warrants to bear 5% interest until paid

---

[1] National banks were prohibited from participating in State insurance plans by ruling in July 1908 of Attorney General of the United States.

[2] In terms of percentage of average daily insured deposits for preceding calendar year, unless otherwise noted. Excludes initial payments or contributions where applicable.

[3] The banking laws of Oklahoma were codified, revised and re-enacted May 25, 1908, with little change in guaranty law.

[4] Special assessments in addition to regular annual assessment authorized 1914-1916.

Source: Annual Report of the Federal Deposit Insurance Corporation for 1952.

Table G6

Maximum Number of Banks Participating in Deposit Insurance, Eight States, 1908-1930

State	Year or years during which number of participating banks was at a maximum	Participating banks		Deposits of participating banks at or near time of maximum participation 1/	
		Number	Percent of all banks 2/	Amount (in thousands)	Percent of all deposits in all banks
Oklahoma	1911	695	75.2%	$ 61,509	50.7%
Kansas	1922	714	52.0	185,989	43.3
Nebraska	1921	1,011	84.3	272,256	57.8
Texas	1921	1,014	58.1	319,346	32.6
Mississippi ..	1921	309	90.9	144,528	77.8
South Dakota .	1921	566	80.6	174,231	67.0
North Dakota .	1920	720	80.6	151,531	66.4
Washington ...	1921	116	29.1	74,859	19.5

[1] For dates nearest beginning of indicated years.

[2] All banks include national, State, and private banks, regardless of eligibility for insurance under the various laws. Excludes trust companies not regularly engaged in deposit banking except for Oklahoma. Dates of data for various categories of uninsured banks used in computi ng percentages are not identical in some instances with dates of insured bank data.

Source: Annual Report of the Federal Deposit Insurance Corporation for 1952.

Table G7

Comparison of Deposit Insurance Programs*

	FDIC	FSLIC
Type of Covered Institution:	Commercial Banks, Mutual Savings Banks	Savings and Loan Associations
Incorporated:	1933	1934
Membership Deposit:	None	None
Annual Premium:	1/12% of deposits, with rebate credit, based upon FDIC net earnings	1/12% of deposits, with rebates which assure a reserve to total insured deposits ratio of at least 1.25%. No rebate credit.
Maximum Coverage:	$100,000 per depositor per bank	$100,000 per depositor per S&L
Number of Insured Institutions:	14,487 Commercial Banks 315 Mutual Savings Banks as of 12/31/82	3,311 as of 1/31/83
Aggregate Amount of Deposits Insured:	$1,104,019 million est. as of 12/31/82	$571,017 million as of 1/31/83
Total Assets-Corporation:	$13.8 billion in deposit insurance as of 12/31/82	$6.40 billion (insurance fund) as of 12/31/82
Reinsurance:	Treasury lines of credit, plus March 1982 Congressional resolution concerning backing of insurance funds by full faith and credit of US Government	Treasury lines of credit, plus March 1982 Congressional resolution concerning backing of insurance funds by full faith and credit of US Government
Gross Claims Paid in 1982 or Most Recent Year:	1982 - $750 million spent in year to facilitate merger or closure of 42 institutions	1982 - assisted 47 mergers, for a present value expense of $1.1 billion
Supervised By:	Independent agency within US Executive Branch	FHLBB
Ratio: Insurance Fund/Deposits:	1.25% - Insured deposits as of 12/31/82	1.12% - Insured deposits as of 12/31/82

*1982 data unless otherwise indicated.

Table G7

Comparison of Deposit Insurance Programs*
(continued)

	Industrial Bank Savings Guaranty Corporation of Colorado	Maryland Savings Share Insurance Corporation
Type of Covered Institution:	Industrial Banks (Coverage Mandatory for all institutions)	Savings and Loan Associations
Incorporated:	1973	1962
Membership Deposit:	None	Assessed individually on new members, and are refundable upon termination of membership. Individual institutions may be required to increase their deposit.
Annual Premium:	If fund falls below the greater of $3 million or 3% of total membership deposits, assessment will be 1/4% of savings deposits	
Maximum Coverage:	$100,000 per depositor entity	$100,000 "for each separate account"
Number of Insured Institutions:	155	105
Aggregate Amount of Deposits Insured:	$320.58 million 6/30/82	$2.455 billion
Total Assets-Corporation:	$7.3 million 6/30/82	$83.851 million
Reinsurance:	None	None as such. However Corporation has available a guaranteed line of credit of $98 million with large commercial banks to provide immediate liquidity
Gross Claims Paid in 1981 or Most Recent Year:	In fiscal year ended 6/30/82, one bank was placed in liquidation by Colorado Bank Commissioner. IBSGC advanced $1,249,000 to cover guaranteed deposit liabilities. Maximum corporate liabilities estimated at $3 million, with 60% expected recovery	1980 - Paid $350,000 to facilitate a merger of two members 1981 - paid a final payment of $2,537,000 to further facilitate same merger.
Supervised By:	Bank Commissioner of State of Colorado	Division of Savings and Loan Associations
Ratio: Insurance Fund/Deposits:	2.28% 6/30/82	3.42% 12/31/81

TABLE G7

Comparison of Deposit Insurance Programs*
(continued)

	Mutual Savings Central Fund Inc. Liquidity and Deposit Insurance Fund	Cooperative Central Fund
Type of Covered Institution:	Savings Banks in Massachusetts (Membership Mandatory)	Savings and Loan Associations (called Cooperative Banks in Massachusetts) (Membership Mandatory)
Incorporated:	1932	1932
Membership Deposit:	Liquidity Fund: May require special assessments as necessary. Last one was in 1957 for 1/20% of member deposits. Power for assessment was eliminated by statute in 1981	Reserve Fund: Similar to Mutual Savings Central Fund
Annual Premium:	Insurance Fund Only: Basic rate of 1/16% of insured deposits. Rate may be charged for any particular year upon aproval of Commissioner of Banks	Share Insurance Fund: Similar to Mutual Savings Central Fund
Maximum Coverage:	All deposits	All deposits
Number of Insured Institutions:	159	111
Aggregate Amount of Depsits Insured:	$11.393 billion	$4.302 billion
Total Assets-Corporation:	$11.39 million - Liquidity Fund $291.18 million - Deposit insurance fund	$151.58 million: $47.91 million in reserve fund $103.67 million in share insurance fund
Reinsurance:	For FDIC members-first "$100,000 for each depositor" insured by FDIC	None as such -- however, CCF has reserved $53 million in lines of credit from commercial banks, for liquidity purposes
Gross Claims Paid in 1982 or Most Recent Year:	Last closing was in 1972, which resulted in the DIF acquiring approximate book value of $24 million in assets. Liquidation continuing	In 1982: (1) Performed assisted merger; granted a $450,000 distribution to facilitate it. (2) Advanced $1,250,000 as interest-free loan to facilitate merger of two members. (3) Two transactions involving one acquiring member bank and four consolidating members. Interest free loans could total $4.4 million by 1988.
Supervised By:	Independent State Chartered Corporation. Some functions performed together with Massachusetts Commissioner of Banks	Independent Corporation. Some function performed together with Commissioner of Banks.
Ratio: Insurance Fund/Deposits:	2.556% 12/31/81	3.52% 8/31/82

TABLE G7

Comparison of Deposit Insurance Programs* (continued)

	North Carolina Savings Guaranty Corporation	Ohio Deposit Guarantee Fund
Type of Covered Institution:	Savings and Loan Associations and Credit Unions	Building and Loan Companies (Savings and Loan Associations)
Incorporated:	1967	1956
Membership Deposit:	1/12% of total savings deposits. However, fee assessed is effectively $1500-2500. Board usually varies the 1/12 fee	Deposit is maintained at 2% of savings balances
Annual Premium:	Each member bank must maintain a deposit of 1.25% of savings deposits - annual assessments made to maintain this level	Membership deposit above is adjusted semi-annually by assessment to maintain membership deposit above
Maximum Coverage:	Up to $100,000 each separate account. (Up to $250,000 each separate IRA account)	All deposits
Number of Insured Institutions:	S&Ls - 45 Credit Unions - 24	80
Aggregate Amount of Depsits Insured:	$2.067 billion	$2.505 billion
Total Assets-Corporations:	$27.17 million	$68.055 million
Reinsurance:	Coverage of $14 million, with $8 million deductible. Also a $50 million line of credit with 2 major commercial banks is kept for liquidity	None
Gross Claims Paid in 1982 or Most Recent Year:	None	Merger of two members in default negotiated in 1982. Fund took back notes in approximate amount of $9.3 million at rates ranging from 9-12%, to facilitate merger.
Supervised By:	Department of Commerce, S&L Division	Ohio Building and Loan Commissioner
Ratio: Insurance Fund/Deposits:	1.31% as of 12/31/81	2.72% as of 6/30/82

TABLE G7

Comparison of Deposit Insurance Programs*
(continued)

	Pennsylvania Savings Association Insurance Corporation	Pennsylvania Deposit Insurance Corporation
Type of Covered Institution:	Savings and Loan Associations	Commercial Banks otherwise uninsured
Incorporated:	1979	1980
Membership Deposit:	2% of savings accounts	
Annual Premium:		1/6% of average deposits, semi-annually
Maximum Coverage:	$100,000 each separate account	$100,000 each separate account
Number of Insured Institutions:	82	4
Aggregate Amount of Depsits Insured:	$97.541 million	$95.0 million
Total Assets-Corporations:	$2.354 million	$306.8 thousand
Reinsurance:	None	None
Gross Claims Paid in 1982 or Most Recent Year:	None	None
Supervised By:	Pennsylvania Commissioner of Banking	Pennsylvania Commissioner of Banking
Ratio: Insurance Fund/Deposits:	2.41% as of 10/31/82	0.32% as of 12/31/82

TABLE G7

Comparison of Deposit Insurance Programs*
(continued)

	California Thrift Guaranty Corporation	Thrift Guaranty Corporation of Hawaii
Type of Covered Institution:	Licensed industrial loan companies which issue thrift obligations. Membership is compulsory.	Industrial loan companies that issue thrift accounts.
Incorporated:	1971	1977
Membership Deposit:	Initial fee equal to 1.5% of outstanding deposits.	Initiation fee of $15,000 may be applied as a credit to any assessment.
Annual Premium:	0.15%	Annual premium equal to 0.50% until the fund equals or exceeds 2% of the total thrift account obligations of all members of the Guaranty Corporation.
Maximum Coverage:	$50,000 per account	$10,000 per account
Number of Insured Institutions:	70	18
Aggregate Amount of Deposits Insured:	$92.5 million	Less than $550 million
Total Assets-Corporations:	$10 million as of 9/30/81	$27.52 million
Reinsurance:	None	Corporation may borrow from the State of Hawaii
Gross Claims Paid in 1982 or Most Recent Year:	Approximately $7 million in 1977	$4.85 million
Supervised By:	State Chartered Corporation supervised by Commissioner of Corporations	State Bank Examiner
Ratio: Insurance Fund/Deposits:	1.08% as of 9/30/81	2.0% as of 12/31/81

TABLE G7

Comparison of Deposit Insurance Programs* (continued)

	Utah Industrial Loan Guaranty Corporation	Kansas Investment Certificate Corporation
Type of Covered Institution:	Industrial loan corporations authorized to accept thrift deposits.	Licensed investment companies (industrial loan corporations) Membership is compulsory.
Incorporated:	1975	1981
Membership Deposit:	Initial fee equal to the greater of $6,000 or the pro rata share of the guaranty fund balance.	Initial deposit of $7,500 plus small fee for certificates on hand.
Annual Premium:	0.25% of outstanding thrift CDs and thrift savings account obligations.	0.25% of deposits
Maximum Coverage:	$10,000 per individual	$10,000 per account
Number of Insured Institutions:	38	12
Aggregate Amount of Deposits Insured:	$387.27 million	$33 million
Total Assets-Corporation:	$1.03 million as of 12/31/82	$550,000 as of 12/31/82
Reinsurance:	None	None
Gross Claims Paid in 1982 or Most Recent Year:	Guaranteed losses of $10 million	None
Supervised By:	Department of Financial Institutions	Consumer Credit Commissioner
Ratio: Insurance Fund/Deposits:	0.266% as of 12/31/82	1.67% as of 12/31/82

TABLE G7

Comparison of Deposit Insurance Programs*
(continued)

	Iowa Thrift Guaranty Corporation
Type of Covered Institution:	Licensed industrial loan companies.
Incorporated:	1981
Membership Deposit:	If deposits $250,000 or less: $2500, if deposits $250,000 to $1 million: $5000, if deposits over $1 million: $10,000
Annual Premium:	If total fund is under $2 million, premium is 1/4%.
Maximum Coverage:	$10,000 per account
Number of Insured Institutions:	89
Aggregate Amount of Depsits Insured:	$181.45 million as of 12/31/82
Total Assets-Corporations:	$1.090 million
Reinsurance:	None
Gross Claims Paid in 1982 or Most Recent Year:	None
Supervised By:	Auditor of the State of Iowa
Ratio: Insurance Fund/Deposits:	0.6% as of 12/31/82

Table G8

Comparison of Share Insurance Plans

[As of 12/31/81]	National Credit Union Administration Insurance Fund	California Credit Union Share Guaranty Corporation	Connecticut Credit Union Share Insurance Corporation	Florida Credit Union Guaranty Corporation
Incorporated:	1970	1981	1973	1975
Membership Deposit:	None	1/2 of 1% of share capital, adjusted annually	1% of shares adjusted annually	1/2 of 1% of net amount guaranteed, adjusted annually $4 mil. + 1/4% of all over $5 mil., adjusted annually
Annual Premium:	1/12 of 1% of all member accounts	1/12 of 1% of shares	1/20 of 1% of shares	1/12 of 1% of funds guaranteed
Maximum Coverage:	$100,000	$150,000	$100,000	$100,000
Number of Insured Credit Unions:	16,951	8	69	211
Number of Credit Union Members:	43,249,912 (Accounts)	135,112	55,000 (est.)	403,218
Total Assets/ Insured CUs:	$64.5 billion	$417,5 million	$52.7 million	$560 million (est.)
Aggregate Amount of Savings:	$57.4 billion	$343.2 million	$46.2 million	$505.6 million
Total Assets-- Corporation:	$177.3 million	$2.06 million	$1.29 million	$3.08 million
Reinsurance:	None - $100 million line of credit - U.S. Treasury	None	None	None
Gross Claims Paid in 1981:	Not available	None	$234,450	$156,692
Supervised by:	National Credit Union Administration	Department of Corporations/ CU Division	Banking Commissioner	Office of State Comptroller
Insurance Mandatory:	For Federal Credit Unions by 12/71	CCUSGC, NCUA or other by by 3/31/81	NCUA by 7/1/83	FCUGC or NCUA by 3/31/77

Table G6

Comparison of Share Insurance Plans
(continued)

[As of 12/31/81]	Georgia Credit Union Deposit Insurance Corporation	Maryland Credit Union Insurance Corporation	Massachusetts Credit Union Share Insurance Corporation	National Deposit Guaranty Corporation (Ohio)
Incorporated:	1974	1975	1961	1974
Membership Deposit:	1% of 1st $1 mil. of shares, deposits, + dividends, + 1/2% of next	1% of shares and deposits adjusted annually	1% of shares and deposits adjusted	1% of shares adjusted annually
Annual Premium:	1/12% of shares, deposits	None	1/12 of 1% of shares and deposits	1/12 of 1% of shares
Maximum Coverage:	$100,000	$100,000	To full account limit	100%
Number of Insured Credit Unions:	134 (also 1 S&L)	29	250	294 (Ohio) 23 (West Va.) 25 (Illinois) 1 (California)
Number of Credit Union Members:	240,365 (est.)	156,917	Not available	Not available
Total Assets/ Insured CUs:	$450.5 million	$304.07 million	$1,653.9 million	$787..6 million
Aggregate Amount of Savings	$420.6 million (Credit unions) $11.6 million (S&Ls)	$276.8 million	$1,611.6 million	$728.8 million
Total Assets/ Corporation:	$2.35 million	$3.33 million	$21.15 million	$8.58 million
Reinsurance:	$3,000,000 Aetna Casualty and Surety	None	None	None
Gross Claims Paid in 1981:	$19,430	$50,589	$2.0 million	$138,204
Supervised by:	Department of Banking and Finance	State Banking Commissioner	Banking Department	Department of Commerce
Insurance Mandatory:	GCUDIC or NCUA by 4/1/78	MCUIC Only 7/1/76	MCUSIC or NCUA 10/73	ACUGA or NCUA by 12/31/78

Table G8

Comparison of Share Insurance Plans
(continued)

[As of 12/31/81]	Nebraska Depository Institution Guaranty Corporation	New Mexico Credit Union Share Insurance Corporation	North Carolina Savings Guaranty Corporation	Rhode Island Share & Deposit Indemnity Corporation
Incorporated:	1978	1973	1967	1969
Membership Deposit:	1% of shares, savings, and deposits	1% of shares and deposits adjusted semi-annually	1.25% of insured savings, adjusted semi-annually	1% of insurable deposits adjusted semi-annually
Annual Premium:	Up to 1/10 of 1% of shares, savings deposits, and certificates of indebtedness	Up to 1/12 of 1% of shares and deposits	Up to 1/12 of 1% of insured savings	1/12 of 1% of shares and deposits
Maximum Coverage:	$30,000	$100,000	$100,000	$100,000
Number of Insured Credit Unions:	2 (also 47 other institutions	17	24 (also 45 savings and loans)	60 (also 12 other institutions)
Number of Credit Union Members:	659 (CUs) 38,851 (Others)	30,000 (est.)	Not available	333,017
Total Assets/ Insured CUs:	$476,189 (Credit Unions) $348,937,785 (Others)	$45 million (est.)	$595.2 million (Credit Unions) $1,714.2 million (Savings & Loans)	$584.3 million (Credit Unions) $507.9 million (Others)
Aggregate Amount of Savings:	$388,503 (CUs) $296,658,569 (Others)	$37.5 million (est.)	$513.6 million (CUs) $1,553.5 million (S&Ls)	$531.6 million (CUs) $373.1 million (Others)
Total Assets-- Corporation:	$2.88 million	Not available	$27.1 million	$13.1 million
Reinsurance:	None	None	$14 million	None
Gross Claims Paid in 1981:	None	$1.0 million	None	None
Supervised by:	Department of Banking and Finance	Banking Commission	Department of Commerce/S&L Division	Department of Business Regulation
Insurance Mandatory:	NDIGC or NCUA by 1/1/83	NMCUSIC or NCUA by 7/1/75	NCSGC or NCUA by 7/1/75	RISDIC or NCUA by 1982

Table G8

Comparison of Share Insurance Plans
(continued)

[As of 12/31/83]	Secured Savings Credit Union of Kansas	State Credit Union Share Insurance Corp. (Tennessee)	Texas Share Guaranty Credit Union	Utah Share & Deposit Guaranty Corporation
Incorporated:	1975	1974	1975	1973
Membership Deposit:	1% of insured savings adjusted	1% of savings capital adjusted	1% of insured savings adjusted	1/2 of 1% assets adjusted annuall
Annual Premium:	1/10 of 1/20 of 1% of insured savings	1/12 of 1% of shares and deposits	Up to 1/10 of 1% of insured savings	1/20 of 1% of shares and deposits
Maximum Coverage:	$100,000	$100,000	$100,000	No maximum
Number of Insured Credit Unions:	94	315 (Tennessee) 68 (Missouri)	412	181
Number of Credit Union Members:	114,906	Not available	861,000	307,844
Total Assets/ Insured CUs:	$169.4 million	$696.3 million	$1,451.1 million	$295.8 million
Aggregate Amount of Savings:	$153.2 million	$625.1 million	$1,298.3 million	$276.8 million
Total Assets--Corporation:	$2.08 million	$10.3 million	$16.31 million	$2.25 million
Reinsurance:	None	None	$5 million	None
Gross Claims Paid in 1981:	$17,938	$520,298	$2,294,806	$1,981,699
Supervised by:	Credit Union Department	Banking Commissioner	Texas Credit Union Department	Examined by Insurance Commission or Department of Fin. Inst.
Insurance Mandatory:	SSCU or NCUA by 6/30/80	SCUSIC or NCUA by 1/1/79	TSGCU or NCUA by 7/1/76	USDGC, NCUA or other by 9/1/81

Table G8

Comparison of Share Insurance Plans
(continued)

[As of 12/31/81]	Virginia Credit Union Share Insurance Corporation	Washington Credit Union Share Guaranty Association	Wisconsin Credit Union Savings Insurance Corporation	Program for Shares & Deposits Insurance Fund (Puerto Rico)
Incorporated:	1974	1975	1970	1961
Membership Deposit:	1% of shares adjusted annually	$25 plus CU held contingency reserves of 1/2 of 1% of total insurable shares and deposits	1/2 of 1% of savings capital	1% of total savings and deposits
Annual Premium:	1/12 of 1% of shares	1/45 of 1% of insurable shares and deposits added to contingency reserves	1/12 of 1% of savings capital	Set by Board of Directors
Maximum Coverage:	$100,000	$100,000	$100,000	$40,000
Number of Insured Credit Unions:	123	169	601	105
Number of Credit Union Members:	190,746	456,432	1,104,224	Not available
Total Assets/ Insured CUs:	$194.02 million	$817.5 million	$1,966.3 million	$356.4 million
Aggregate Amount of Savings:	$163.86 million	$721.6 million	$1,812.4 million	$309.9 million
Total Assets-- Corporation:	$2.6 million	$1.9 million	$14.45 million	$2.75 million
Reinsurance:	$2 million	None	None	$4 million Commonwealth Government Guarantee
Gross Claims Paid in 1981:	$19,910	$169,716	$169,459	Not available
Supervised by:	Bureau of Banking	Supervisor, Division of Savings & Loan Associations	Commissioner of Credit Unions	Inspector of Co-operatives
Insurance Mandatory:	VCUSIC or NCUA by 7/1/76	WCUSGA or NCUA by 12/28/75	WCUSIC Only	PSDIF by 6/1/82

Table G8

Comparison of Share Insurance Plans
(continued)

[As of 12/31/81]	Credit Union Reserve Board (British Columbia)	Ontario Share & Deposit Insurance Corporation
Incorporated:	1958	1977
Membership Deposit:	1% of shares and deposits, adjusted annually	1% of savings and deposits
Annual Premium:	.1% of shares and deposits	None
Maximum Coverage:	No maximum	$20,000
Number of Insured Credit Unions:	153	1,000
Number of Credit Union Members:	955,000 (est.)	1,846,375
Total Assets/ Insured CUs:	$4,949 million (est.)	$4.89 billion
Aggregate Amount of Savings:	$4,740 million (est.)	$4.58 billion
Total Assets-- Corporation:	$53.6 million	$47.2 million
Reinsurance:	None	None
Gross Claims Paid in 1981:	$606,254 (Gross)	None
Supervised by:	Provincial Government	Provincial Government
Insurance Mandatory:	Mandatory	OSDIC by 12/1/77

Source: 1982 Yearbook State Share Insurance published by the International Share and Deposit Guaranty Association in cooperation with the Credit Union National Association.

BIBLIOGRAPHY

Alexander, Ronald E., "The Ohio Alternative to FSLIC." Akron Law Review, Winter 1982.

Berle, Adolph A., Jr., The Bank that Banks Built: The Story of Savings Bank Trust Company, 1933-1958. New York: Harper & Brothers, 1959.

Ewalt, Josephine Hedges, A Business Reborn. Chicago, Illinois: American Savings and Loan Institute Press, 1962.

Federal Deposit Insurance Corporation. Annual Report, 1934, 1950, 1952, and 1953.

Golembe, Carter H. and Warburton, Clark, Insurance of Bank Obligations in Six States. Washington, D.C.: Federal Deposit Insurance Corporation, 1958.

Leff, Gary and Park, James W., "The Mississippi Deposit Insurance Crisis." Bankers Magazine, Summer 1977.

National Association of Bank Auditors and Comptrollers, Federal Deposit Insurance. Chicago, Illinois: National Association of Bank Auditors and Comptrollers, 1946.

Robb, Thomas Bruce, The Guaranty of Bank Deposits. Boston and New York: Houghton Mifflin Company, 1921.

Ross, Nancy L., "Investors Having Doubts About High-Yield Saving." Washington Post, August 15, 1982.

Slater, Karen, "Adequacy of State Insurance Funds for Thrifts Under Scrutiny in Current Crisis." American Banker, May 10, 1982.

State Share Insurance Yearbook, 1982. Atlanta, Georgia: International Share and Deposit Guaranty Association in cooperation with the Credit Union National Association, 1982.

Warburton, Clark, Deposit Insurance in Eight States During the Period 1908-1930. Washington, D.C.: Federal Deposit Insurance Corporation, 1959.

Welfling, Weldon, Mutual Savings Banks. Cleveland, Ohio: Case Western Reserve University Press, 1968.

AGENDA FOR REFORM

A report on deposit insurance
to the Congress from the
Federal Home Loan Bank Board

Richard T. Pratt
Chairman

Jamie Jay Jackson
Board Member

Washington, D.C.
March 23, 1983

Federal Home Loan Bank Board

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

RICHARD T. PRATT
CHAIRMAN

March 23, 1983

Honorable Jake Garn
Chairman
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Honorable Fernand J. St Germain
Chairman
Committee on Banking, Finance
and Urban Affairs
House of Representatives
Washington, D.C. 20515

Dear Chairmen:

It is with pleasure that I transmit the Board's report, Agenda for Reform, A Report on Deposit Insurance to the Congress from the Federal Home Loan Bank Board, to your Committees pursuant to Section 712 of the Garn-St Germain Depository Institutions Act of 1982.

The Bank Board believes that without reforms, recent public gains resulting from financial deregulation may be jeopardized. Further, the Board believes that reform should be initiated to bring federal policies in line with modern financial markets. The Board appreciates this opportunity to submit our Agenda for Reform as our best judgment on how this agency and the Congress should proceed to ensure efficient and competitive financial markets for the American public.

The Board prepared this report with the invaluable help of a Drafting Committee of distinguished scholars, Commentators who represented a broad range of professional expertise, and Bank Board staff. The views and recommendations presented in this report, however, are those of the Federal Home Loan Bank Board and do not necessarily represent the views of the Commentators or members of the Drafting Committee.

Respectfully,

Richard T. Pratt

Richard T. Pratt

COMMENTATORS

Herbert W. Cummings
Providence,
Rhode Island

Gene Donovan
Salt Lake City,
Utah

Edward E. Edwards
Bloomington,
Indiana

Walter E. Erikson
New York,
New York

James R. Faulstich
Seattle,
Washington

Anthony M. Frank
San Francisco,
California

Mary A. Grigsby
Houston,
Texas

Charles W. Havens III
Washington, D.C.

Leon T. Kendall
Milwaukee,
Wisconsin

Gerald J. Levy
Milwaukee,
Wisconsin

Lewis S. Ranieri
New York,
New York

Gilbert G. Roessner
Elizabeth,
New Jersey

REPORT STAFF

Staff Director

Charlotte A. Chamberlain

Deputy Staff Director

Jerry Hartzog

Senior Policy Analysts

FHLBB Economic Analysts

R. Dan Brumbaugh
Henry J. Cassidy
Bowers W. Espy
Paul T. Peterson

FHLBB Legal Analysts

Peter M. Barnett
Michael D. Schley

Editorial Staff

Joseph Foote
Mary E. Cadette
Bonnie J. Brown

Design

Peter Kemble

Drafting Committee

Tim S. Campbell
University of
Southern California
Gerald O. Bierwag
University of Arizona
Fischer Black
Massachusetts Institute
of Technology
Andrew S. Carron
The Brookings Institution
David W. Glenn
University of Utah
Paul M. Horvitz
University of Houston
George G. Kaufman
Loyola University
of Chicago

CONTENTS

Page

PREFACE. 1

Origins and Scope of the Study 3

BANK BOARD AGENDA FOR REFORM

RECOMMENDATIONS OF THE FEDERAL HOME LOAN BANK BOARD. 7

Accounting Information and Disclosure. 9

Variable-Rate Premiums 10

Private Insurance. 10

Fiduciary Responsibility 11

Capital Adequacy 12

Regulatory Reform 12

FRAMING THE ISSUES 15

RESPONDING TO CRISES 19

FUNCTIONS OF DEPOSIT INSURANCE 25

Deposit Insurance and Failing Institutions 27

SUMMARY OF THE ISSUES. 29

Replacing Direct Controls. 29

Maintaining Public Confidence. 33

Page

Pricing Risk 36

Expanding Private Insurance. 40

Rethinking Regulatory Structure. 43

SECTION I

RESPONDING TO CRISES 49

HISTORICAL PERSPECTIVE ON THE EVOLUTION OF DEPOSIT INSURANCE. 54

Commercial Banking in the United States Before 1930. 55

The Banking Crisis of the Early 1930s. 57

Impact on the Savings and Loan Industry. 59

The Advent of Deposit Insurance. 60

Housing Policy and the Creation of the FSLIC 61

THE CURRENT CRISIS 65

Thirty Years of Stability: 1935-1965. 66

The Significance of "Regulation Q" 68

The Impact of High and Volatile Interest Rates 69

Technological Change and Market Innovations. 70

OUTLOOK FOR THE SAVINGS AND LOAN INDUSTRY. 73

The Commitment to Housing as Social Policy 79

Deregulation vs. Reregulation. 81

SUMMARY. 82

Page

SECTION II

REPLACING DIRECT CONTROLS. 85

MARKET DISCIPLINE. 90

Uninsured Deposits 91

Risk Sensitivity of Uninsured Depositors 96

Assessing Risk in Savings and Loan Associations. 101

Other Implications of Altering Insurance Coverage. 103

MEANS OF ACHIEVING MARKET DISCIPLINE 105

Mutual vs. Stock Organization. 110

EFFECTS OF ALTERED DEPOSIT INSURANCE COVERAGE. 113

Macroeconomic Effects. 113

Effects on Depositors. 115

Effects on Financial Structure 116

Effect on the Cost and Risk of the Insurance System. 119

Other Effects. 122

FINANCIAL DISCLOSURE AND DEPOSIT INSURANCE 123

Disclosure and Insured Depositors. 125

Disclosure and Uninsured Creditors 126

Disclosure and Stockholders. 129

Information to Be Disclosed. 131

SUMMARY. 134

Page

SECTION III

MAINTAINING PUBLIC CONFIDENCE. 137

THE NUMBER OF TROUBLED S&Ls. 140

Simulation Model 142

Traditional Sources of Risk. 144

New Sources of Risk. 148

New techniques and instruments. 151

HANDLING TROUBLED INSTITUTIONS 153

Alternatives to Merger 156

TIMING OF FSLIC ACTION 160

THE FUTURE ADEQUACY OF THE FUND. 162

SUMMARY. 169

SECTION IV

PRICING RISK. 171

The Need for Risk-Sensitive Premiums. 174

Risk Management Tools 177

Sources of Risk 180

OVERALL RISK INDICATORS 183

Examinations Ratings. 183

Financial Ratios. 184

Page

Past Loan and Security Losses 186

Past Levels and Volatility of Earnings. 187

Interest Rate on Uninsured Deposits 187

INDIVIDUAL RISK MEASURES. 189

Interest Rate Risk. 189

Measuring interest rate risk 190

Mark-to-market (duration gap) approach 200

Maturity gap analysis approach 201

Default Risk. 201

Market-determined risk premiums. 202

Historical loan losses 204

Diversification. 205

Management Risk 207

SUMMARY 209

SECTION V

EXPANDING PRIVATE INSURANCE 211

THE PRINCIPLES OF PRIVATE INSURANCE 217

CASUALTY INSURANCE. 221

Insurance of Catastrophic Loss. 222

Nuclear Insurance 223

Page

FINANCIAL GUARANTEES. 227

Letters of Credit 227

Surety Bonds. 228

Mortgage Insurance. 229

Bond Insurance. 233

FEASIBILITY OF PRIVATE DEPOSIT INSURANCE. 235

Types of Hazards. 235

Robberies and fraud by outsiders 236

Misappropriation of funds by insiders. 237

Normal management failures 238

Failures of national macroeconomic policy. 239

Alternative Forms of Joint Public-Private Deposit Insurance 242

Mechanisms for limiting loss exposure. 246

Mechanisms for distributing loss exposure 250

Pricing. 255

Regulation of insurers 258

Adverse selection potential. 259

Right of cancellation. 260

SUMMARY 261

SECTION VI

RETHINKING REGULATORY STRUCTURE 263

THE STRUCTURE OF FEDERAL DEPOSIT INSURANCE. 267

Page

Establishment and Control 268

Coverage and Powers 272

Financial Structure 275

ISSUES IN CONSOLIDATION 279

Legal Aspects 279

Powers of a Deposit Insurance Agency. 283

- Alternative forms of organization. 286
- Regulatory capture 290
- Gaps, overlap, and duplication 291
- Coordination of assistance operations. 294
- Competing objectives 298

Competition Among Regulators. 300

Cost Savings from Consolidation 306

- Overhead expense 306
- Size of the fund 309

Cross-Industry Transactions 310

- Mergers and acquisitions 311
- Change of charter. 311
- Multi-industry activities. 312
- Coordination vs. consolidation 312

Risk Differences Among Insured Institutions 313

Transition Issues 315

REFORM PROPOSALS. 319

Brookings Study (1937). 320

Page

Legislative Proposals (1938-1939) 321

The Hoover Commission (1949). 321

Reorganization Plan No. 2 (1956). 322

Commission on Money and Credit (1961) 324

H.R. 729 and 4253 (1963). 324

Senate Investigation into Federally Insured Banks (1965). 325

The Hunt Commission (1971). 327

The Financial Institutions Act of 1973. 328

The Federal Banking Commission (1973) 329

Compendium of Major Issues in Bank Regulation (1975). . . . 330

FINE Study (1975) 332

The Consolidated Banking Regulation Act of 1979 335

Garn-St Germain Depository Institutions Act of 1982 337

Current Reform Proposals. 337

SUMMARY 339

APPENDIX A

INDEXES OF RISK 345

COMBINING SEPARATE RISK INDEXES 347

An Expected Value Approach. 348

Implications of Combining Separate Indexes. 358

Adjustments for Net Worth 359

Page

INTEREST RATE RISK EXPOSURE 363

Steps to the Interest Rate Risk Index 371

An Illustration of the Interest Rate Index. 372

APPENDIX B

REFERENCES. 379

SECTION I. RESPONDING TO CRISES. 381

SECTION II. REPLACING DIRECT CONTROLS. 381

SECTION V. EXPANDING PRIVATE INSURANCE 381

SECTION VI. RETHINKING REGULATORY STRUCTURE. 382

APPENDIX A. INDEXES OF RISK. 384

APPENDIX C

BIBLIOGRAPHY. 385

APPENDIX D

BIOGRAPHIES 397

APPENDIX E

FEDERAL HOME LOAN BANK BOARD MASTHEAD 413

PREFACE

(259)

The Federal Home Loan Bank Board (FHLBB) is issuing this report at a time of unprecedented change in the savings and loan industry--change brought about by social, economic, and technological forces. The Bank Board believes that the nation is entering a time of profound decision about its financial institutions, including savings and loan associations. Decisions must be made about federal policy, about the structure of the financial institution market, about the services offered to the public, about the safety and security of people's savings.

The choice before the nation is between reform or return to the regulatory approach that has characterized government policy for the past half-century. The Bank Board believes that the preferable route is reform, to bring federal policies into line with the realities of modern financial markets. This report is submitted by the Bank Board with the expectation that it will contribute to the broad national debate that is now needed on deposit insurance.

Origins and Scope of the Study

The origins of this report are in initial work conducted by the Committee on Banking, Finance and Urban Affairs of the House of Representatives and of the Committee on Banking, Housing, and Urban Affairs of the Senate. The mandate for a major study of deposit insurance was embodied in Section 712 of the Garn-St Germain

Depository Institutions Act of 1982 (Public Law 97-320). Major provisions of that law are summarized in Section I of this report.

Shortly after President Reagan signed the Garn-St Germain Act into law on October 15, 1982, the Bank Board directed its Office of Policy and Economic Research to begin work on the study. At the first meeting on the project on November 9, 1982, Chairman Richard T. Pratt and Bank Board Member Jamie Jay Jackson issued a broad mandate to the study team, directing it to prepare a report that not only would answer the Congressional questions, but also would provide the larger analytical framework necessary for a sound and rational approach to statutory and regulatory reform.

The Bank Board prepared the analytical framework for this study and oversaw development of the policy aspects of the report at all stages. A Drafting Committee of prominent economists prepared initial manuscripts that were reviewed by a distinguished group of Commentators drawn from the financial, legal, academic, and business communities. This process proved invaluable to the Bank Board in developing its response to the Congressional mandate. Brief biographies of the Commentators and members of the Drafting Committee are contained in Appendix D.

The study focused on the points set out in Section 712(a) of the Garn-St Germain Act:

(1) the current system of deposit insurance and its impact on the structure and operations of depository institutions;

(2) the feasibility of providing depositors the option to purchase additional deposit insurance covering deposits in excess of the general limit provided by law and the capabilities of the private insurance system, either directly or through reinsurance, to provide risk coverage in excess of the general statutory limit;

(3) the feasibility of basing deposit insurance premiums on the risk posed by either the insured institution or the category or size of the depository institution rather than the present flat rate system;

(4) the impact of expanding coverage of insured deposits upon the operations of the insurance funds, including the possibility of increased or undue risk to the funds;

(5) the feasibility of revising the deposit insurance system to provide even greater protection for smaller depositors while fostering a greater degree of discipline with respect to large depositors;

(6) the adequacy of existing public disclosure regarding the condition and business practices of insured depository institutions, and providing an assessment of changes which may be needed to assure adequate public disclosure;

(7) the feasibility of consolidating the three separate funds; and

(8) other related issues.

The three funds referred to are those of the Federal Savings and Loan Insurance Corporation, the Federal Deposit Insurance Corporation, and the National Credit Union Administration.

The final text of this report reflects the views and recommendations of the Federal Home Loan Bank Board and does not necessarily represent the views of the Commentators or members of the Drafting Committee.

The Bank Board wishes to express its appreciation to all of those who served as Commentators for this study. These people gave freely of their time and knowledge in exceptionally far-ranging and open discussion of the issues addressed in this report. The Bank Board also thanks the members of the Drafting Committee for their service. The Bank Board especially recognizes the contributions of the FHLBB economists and other experts, as well as members of the legal staff, who made significant contributions to this study.

Washington, D.C.
March 23, 1983

BANK BOARD AGENDA FOR REFORM

RECOMMENDATIONS OF THE FEDERAL HOME LOAN BANK BOARD

The Federal Home Loan Bank Board (FHLBB) proposes in the broadest sense an approach that would effectively address the current system of financial institutions. This approach is designed to bring that system into equilibrium and control the risk exposure of the FSLIC while maintaining the benefits of deregulation to the public. This approach consists of six areas, which are: (1) the development of an improved reporting framework designed to provide meaningful management and financial information, which would be combined with substantially expanded disclosure requirements; (2) the development of a partially variable insurance premium based on measurable risks; (3) the development of co-insurance or private insurance designed to increase market discipline associated with financial institutions' acquisition and investment of funds; (4) an active role in holding institutions' officers and directors responsible for prudent stewardship of the deposits insured by the FSLIC; (5) ensuring that adequate capital is maintained in thrift institutions to limit the risk exposure of the FSLIC; and (6) the evaluation of the current regulatory structure with respect to its impact on the marketplace and the implementation of regulatory reforms designed to allow for more efficient administration of regulatory responsibilities.

Accounting Information and Disclosure

Reforms designed to reduce the FSLIC's exposure to risk through market discipline in a deregulated industry will be enhanced to the extent that depositors, investors, and managers are fully informed about the financial condition of associations. Appropriate reporting, which would include current value financial information, is essential. In addition, the fullest possible public disclosure of information on performance and financial condition is also required.

Variable-Rate Premiums

The Board believes that variable-rate insurance premiums for the FSLIC should be adopted. The present insurance structure of charging level premiums based on deposit level bears no rational relationship to risks imposed on the FSLIC by the insured institution. Aggressive risk-taking institutions are imposing risks far beyond the level of their insurance premiums, while institutions pursuing a less aggressive posture, both in interest rate risk and default risk, may be paying excess premiums. The Board believes that a variable-rate insurance premium should be based on the major measurable aspects of risk. These include interest rate risk, default risk, and capital adequacy. Implementation of a variable-rate premium should be done over time, using a transition period during which the effects of a variable-rate premium can be monitored.

Private Insurance

Substitution of complete private insurance for federal deposit insurance does not appear to be feasible at this time. However, private participation in the deposit insurance function may be both possible and desirable. Technological changes allowing efficient brokerage of deposit funds, combined with the deregulation of interest rates on time and savings deposits, have given financial institutions an almost unlimited ability to attract funds on a quasi-governmental basis. At the same time, deregulation of the asset side of financial institutions has created the opportunity for substantial risk-taking in savings and loan investments. As a result of these developments, depositors are totally insured regardless of the riskiness of investment activities undertaken by the institution. As a result, depositors, investors, and creditors in insured institutions provide no market discipline to these institutions. Development of a co-insurance approach involving either uninsured or privately insured funds combined with more complete disclosure requirements on the part of financial institutions could ensure rational allocation of funds and bring market discipline to the depository institutions market.

Fiduciary Responsibility

As the Congress and the Board have moved to remove legislative and regulatory restrictions on the operations of financial institutions, the obligation to act responsibly and knowledgeably falls directly on the directors and managers of those institutions. The Board must aggressively pursue those directors and managers who are unwilling to accept this self-discipline.

Capital Adequacy

The Federal Home Loan Bank Board believes that thrift institutions should have the maximum ability to obtain new equity capital for their institutions. This capital provides the greatest safeguards to the FSLIC and is the most effective way of ensuring some management accountability. In this regard the Bank Board intends to facilitate the ability of mutual institutions, desiring to convert to stock form, to do so in the easiest and most efficient manner possible. The Bank Board believes that adequate capital must be maintained in thrift institutions if risk to the FSLIC is to be limited to prudent levels. The existence of risk capital subordinated to the FSLIC guarantee is mandatory if the risk exposure of the FSLIC is to be contained to a manageable level.

Regulatory Reform

The most significant costs associated with financial regulation stem from resulting inefficiencies in the marketplace. Administrative costs and duplication of effort under the current regulatory structure play a much smaller role in the evaluation of regulatory reform. The Bank Board believes that it presently has a highly effective structure for addressing the broad implications of regulatory action and for implementing regulatory reforms, incorporating under its auspices many of the functions that three separate agencies--the Federal Reserve, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation--presently perform for commercial banks.

FRAMING THE ISSUES

(273)

Federal deposit insurance was created during the Great Depression as a way of restoring public confidence in the U.S. financial system. Indeed, the legislation developed and installed a new financial structure for the nation. As stability gradually returned, banks and thrifts regained their health and grew at a measured pace under close government regulation.

More recently, however, conditions in financial markets have become increasingly volatile. Additional pressures on regulated depository institutions have resulted from the innovations of unregulated firms and investors. Deregulation has occurred in many sectors of the economy, with substantial changes taking place in the financial services industry.

Partial deregulation, however, has created its own problems. Deposit insurance was designed for one regulatory structure, but a very different one is now developing. The current system is unstable; without reform, it threatens the viability of federal deposit insurance. One alternative would be to revert to the previous regime of rigid controls. Although possible, that course of action is impractical because innovation is continuous and economic stability elusive. A realistic alternative is further reform that would preserve an acceptable level of government supervision while encouraging maximum private initiative--consistent with the protection of insured depositors and the viability of the financial markets.

This is the philosophy that has motivated the current discussion of reform. Reflecting this philosophy, the Federal Home Loan Bank Board (FHLBB) proposes in the broadest sense an approach that would effectively address the current system of financial institutions. This approach is designed to bring the system into equilibrium and to control the risk exposure of the FSLIC while maintaining the benefits of deregulation to the public. This approach consists of six parts: (1) the development of an improved reporting framework designed to provide meaningful management and financial information, which would be combined with substantially expanded disclosure requirements; (2) the development of a partially variable insurance premium based on measurable risks; (3) the development of co-insurance or private insurance designed to increase market discipline associated with financial institutions' acquisition and investment of funds; (4) an active role in holding institutions' officers and directors responsible for prudent stewardship of the deposits insured by the FSLIC; (5) ensuring that adequate capital is maintained in thrift institutions to limit the risk exposure of the FSLIC; and (6) the evaluation of the current regulatory structure with respect to its impact on the marketplace and the implementation of regulatory reforms designed to allow for more efficient administration of regulatory responsibilities.

RESPONDING TO CRISES

Before the Great Depression there were few restrictions on financial institutions. Banks in particular had substantial discretion in choosing investments, entering new lines of business, and expanding the scope of their operations. Federal deposit insurance did not exist. Even small and unsophisticated depositors took on the role of investors as they placed their savings at risk. Thrift institutions invested heavily in residential mortgages, then as today, but the character of the instrument was different. Most mortgages of the time were short-term interest-only notes, implying the need to pay off or refinance the balance within a few years. Because this system was so open, so unregulated, there was always the chance of a collapse.

That potential was vividly realized in the early 1930s. Depressed economic conditions led to defaults on commercial loans and home mortgages. Financial institutions, denied the income from loans in default, failed in record numbers. Some depositors lost everything; others cashed out their deposits in time, bringing down more institutions. Massive withdrawals from the banks, combined with the passivity of the Federal Reserve, collapsed the money supply and put a greater drag on the economy. Thrift institutions were unable to roll over maturing short-term loans, and forced more home owners into default by calling the notes. Other institutions failed because they had speculated in stocks with the deposits they held.

Each of these problems found a response in the series of laws passed beginning in 1932. Federal deposit insurance was used to stabilize the money supply by removing the incentive for customers to withdraw their funds at the first sign of trouble. The federal government became involved in the chartering and regulation of savings and loan associations (S&Ls) to reconstruct a shattered housing market. Long-term, fully amortizing mortgage loans, pioneered by the Federal Housing Administration, spread the burden of financing a home evenly over many years to minimize the likelihood of default. Other legislation restricted the investment activities of banks to prevent the abuses that had contributed to the severity of the Depression. This new system was tightly regulated. Institutions were to be more highly specialized and their entry into new lines of business was limited. Further layers of control were added later--branching restrictions, interest rate ceilings, and prohibitions on alternative mortgage instruments.

The system functioned well when economic conditions were stable, as they were from the 1930s into the 1960s, and there was no incentive to circumvent the controls. The greatest growth period for the savings and loan industry came in the 1950s, when the demand for housing and mortgages was strong and interest rates were low and stable. There were few pressures on the insurance system; in every year, the income of the FSLIC exceeded its expenses. Table F-1 shows selected income and expense measures for the corporation since 1935.

In retrospect, however, the stability of the 1940s and 1950s may have been the exception rather than the norm. As market conditions changed, depository institutions were motivated to shift their activities, but they were constrained by regulation. Substantial disequilibrium resulted, setting certain irreversible forces in motion.

In the early 1960s, the federal government began to pursue a more activist policy. With more rapid economic growth came higher inflation and interest rates. Savings and loan associations faced a dilemma: meeting investors' demands for higher rates would have created operating losses, while adhering to a policy of rate ceilings would have induced depositors to withdraw their funds. Stricter rate ceilings were successful as long as investors had only limited opportunities outside the regulated depository sector. But alternatives eventually developed--for example, electronic funds transfer systems made money market mutual funds possible. Regulation thus became less effective in protecting the system while the constraints of regulation became more binding. Partial deregulation, such as the authorization of money market certificates in 1978, created new problems even as it alleviated others.

These changes were felt by the deposit insurance system. In 1981, the FSLIC resolved 30 cases of failing savings and loan

Table F-1. FSLIC Selected Income and Expenses

(Dollar Amounts in Millions)

	Premiums & Other Income	Expenses	Net Income
1982	$1,059	$957	$102
1981	1,021	980	32
1980	941	162	779
1970	265	114	151
1960	54	1	53
1950	13	3	10
1940	6	0	6
1935	3	3	0

Source: Federal Savings and Loan Insurance Corporation.

associations at a net cost of $1.0 billion. During 1982, the number of cases increased to 77, and the cost was $1.1 billion. As Table F-2 indicates, for these two years alone, the FSLIC provided assistance nearly equal to the sum of all such aid provided between its creation in 1934 and the beginning of the crisis in 1980.

Further regulatory reform resulted. The Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Depository Institutions Act of 1982 have brightened the long-term prospects of the savings and loan industry. This legislation and new regulations permit S&Ls to adjust to increasing competition and volatile interest rates. Savings and loan associations have received broadened powers in many areas, including deposit interest rate ceilings, brokered funds, nondeposit borrowing, collateralized borrowing, financial futures, debt options, commercial loans, transactions accounts, alternative mortgage loans, service corporations, and security purchases. However, this increased flexibility conflicts with the existing deposit insurance system. That system must adapt. Before evaluating possible changes in the structure of the deposit insurance system, however, it is important to understand the evolving role of deposit insurance in financial markets.

Table F-2. Federal Savings and Loan Insurance Corporation Assistance

	Number of Cases	Assets (Millions)	Cost of Assistance (Millions)
1982	77	$28,360.7	$1,131.2 [a]
1981	30	13,882.6	987.9 [a]
1980	11	1,457.7	166.6 [a]
1970-79	43	2,688.7	235.0
1960-69	43	1,670.6	103.9
1950-59	4	24.5	0.0
1940-49	27	48.9	3.3
1935-39	13	23.1	1.9

[a] Estimated present value of assistance; all other years represent net outlays.

Source: Federal Savings and Loan Insurance Corporation.

FUNCTIONS OF DEPOSIT INSURANCE

Reliance on market forces usually leads to the efficient allocation of resources. An exception to this general principle occurs with the presence of significant imperfections in the market. A common type of market failure occurs when the actions of one firm impose costs or benefits that spread beyond that firm--what economists call externalities. The presence of such external effects provides a substantial justification for federal deposit insurance.

Deposit insurance is a means of protecting the money supply. When demand deposit accounts are withdrawn in large numbers, as they were in the early years of the Great Depression, the money supply shrinks abruptly, exerting a strong retarding influence on economic growth. The Federal Deposit Insurance Corporation (FDIC) was established to reassure holders of demand deposits and thus minimize the possibility of such shocks to the money supply.

A related function of deposit insurance is to prevent problems associated with one financial institution from spreading to others. The financial system is known to be substantially interconnected. If one bank or thrift institution is found to be in trouble, depositors might infer that other firms are similarly afflicted. The externality in this instance is between firms, rather than between the industry and the economy.

Deposit insurance plays a part in routine transactions as well, and that is an equally important rationale for federal involvement. In the absence of government deposit insurance, each saver would have to investigate the soundness of financial institutions. For many small investors, the costs of searching out a sound institution would exceed the benefits derived from holding deposits rather than cash. Some investors might not be able to evaluate the alternatives. Moreover, the millions of investigations would be highly inefficient because of the duplication involved. Private firms might take it upon themselves to perform such analyses, but they would charge for the service; and for investors, the problem of assessing depository institutions would be replaced by the problem of judging rating agencies. Through deposit insurance, the federal government examines and, in effect, certifies institutions on behalf of the millions of individual depositors. This leads to a more efficient result than would exclusive reliance on market forces.

There are other reasons for deposit insurance. By treating institutions alike, whether large or small, urban or rural, state- or federally chartered, the deposit insurance system permits diversity and decentralization of control. Without FDIC and FSLIC coverage, deposits might be concentrated in the very largest institutions in a few major cities. Sparing small savers the uncertainty and variability of income that would result without deposit insurance is another public-policy goal. Through depository institutions, such investors can pay a small insurance premium in exchange for the assurance of a known return of principal and interest.

Deposit Insurance and Failing Institutions

The Federal Home Loan Bank Board has been successful in handling failing savings and loan associations over the years because the FSLIC embodies much more than the fund's assets. The FHLBB is the FSLIC's board of directors, and the FSLIC can rely on regulatory initiatives from the FHLBB to minimize the risk to which the fund is exposed.

The FSLIC relies first on the FHLBB's Office of Examination and Supervision to provide advance warning and corrective actions to institutions that excessively increase the risk exposure of the FSLIC. This office also enforces the Board's regulatory requirements for S&Ls. These include limits on types of business activities, disclosure requirements, capital requirements, liquidity requirements, and chartering and insurance provisions for new associations.

The FHLBB also oversees the 12 district banks, which indirectly help the FSLIC by extending liquidity to any association with a short-term cash flow problem. The Garn-St Germain Act, moreover, permits the FSLIC to borrow from the district banks.

During the recent crisis, the FHLBB handled problem institutions in several ways. The FHLBB's program of preventing liquidations by purchasing income capital certificates from failing institutions resulted in the "phoenix" institutions in New York, Illinois, and Puerto Rico. Congress through the Garn-St Germain Act modified the concept of the income capital certificate to create net worth certificates that give weak institutions time to restructure. This program allows the FSLIC to issue certificates to bolster an S&L that has net worth below 3 percent of assets; when the institution returns to profitability it must repay the net worth guarantees, with interest, to the FSLIC. Another tool the FSLIC used to reduce its cash outflows for assistance was the solicitation of bids for weak institutions across state lines. Finally, allowing the use of purchase accounting in the recording of merger transactions also reduced FSLIC cash outflows.

Over the past two years, the effectiveness of the procedures described above has meant the difference between exhausting the FSLIC fund and the $134 million increase actually recorded. These procedures have reduced the pre-1981 cost of assistance from an average of 75 percent of the cost of liquidation to the current average of 12 percent.

SUMMARY OF THE ISSUES

The rapidly changing environment in financial markets in recent years has created incongruities between deposit insurance and S&L operations. Federal deposit insurance as currently structured removes discipline from the market even as it corrects imperfections. Under the system in place today, the federal government shares in any losses while gains accrue entirely to those who have interests in depository institutions. A rational course of action in these circumstances is for the firm to engage in activities that may be excessively risky. The reduction of these undesirable side effects of deposit insurance--through replacing direct controls, maintaining public confidence, pricing risk, expanding private insurance, and rethinking federal regulatory structure--is the focus of this report.

Replacing Direct Controls

Each deposit account in federally insured S&Ls is covered up to $100,000. Depositors can increase this coverage by establishing joint accounts or by opening accounts in several institutions. Because deposit insurance eliminates risk for covered account holders, weak institutions can attract deposits on the same terms as financially sound institutions. In effect, deposit insurance increases managerial incentives to accept investment risk while it protects depositors.

Federal regulatory agencies charged with administering federal deposit insurance have sought to manage the risk exposure of insured institutions by regulatory restrictions. Reflecting growing preferences for the deregulation of financial markets and the overall reduction of government intervention in the marketplace, many of these restrictions have been eliminated in the past few years. The FHLBB is therefore seeking alternative methods of managing FSLIC risk exposure.

One frequently suggested approach is to increase insured institutions' participation in the market for uninsured deposits. Conceptually, the price of uninsured deposits will reflect perceived risk (among other factors), thereby encouraging prudent risk management decisions. The effectiveness of this approach in limiting risk exposure depends on the extent to which institutions participate in the market for uninsured deposits, the sensitivity of depositors to perceived risk, and the ability of depositors to determine accurately the riskiness of an individual institution.

A tradeoff results. Although the increased market discipline accompanying uninsured deposits will in the long term induce mangement to operate institutions more conservatively, there may be an interim decline in the viability of individual institutions. An example of this tradeoff is the insurance coverage on large long-term deposits. Currently, the $100,000 insurance limit hampers S&Ls in their efforts to attract long-term funds. Issuing long-term insured deposits over $100,000 would stimulate such deposits and would reduce the maturity mismatch between assets and liabilities. As a result, interest rate risk would decline and financial stability would be easier to maintain. However, although it is clear that the short-term effects would be beneficial, the complete absence of uninsured deposits could seriously erode market discipline in the long term.

A significant body of uninsured depositors is completely lacking at most S&Ls and many commercial banks. (At the end of 1982, 96 percent of all S&L deposits were insured.) Further, recent developments have facilitated arrangements for brokered insured deposit accounts which significantly reduce the cost of circumventing limits on deposit insurance coverage. Consequently, reductions in the level of coverage are not likely to increase the number or amount of uninsured deposits.

If uninsured depositors are to exert market discipline, it is imperative that they perceive their deposits to be at risk. Most failures of FSLIC-insured institutions have been resolved through some form of merger that protects all creditors of the failed institution. Although such policies may minimize agency costs and financial market disruption, they also lessen the concern of uninsured depositors with respect to the riskiness of individual depository institutions. If uninsured depositors believe that such policies will continue, the absence of explicit deposit insurance will not provide the desired market discipline.

Even if uninsured depositors are perceived to be at risk, discretionary market discipline can only be exerted if enough accurate information concerning the condition of individual institutions is available. Disclosure of such information must be timely and frequent to allow uninsured depositors to evaluate risk continuously and adjust their asset holdings accordingly. In order to provide adequate information, appropriate reporting, which would include current value financial information, is essential.

Various measures can be taken to increase depository institutions' participation in the market for uninsured deposits. The current ceiling on deposit insurance could remain unchanged, allowing inflation to reduce the real level of coverage over time. Other options include the use of graduated coverage limits, the elimination of insurance on all deposits (excluding transaction accounts), and requiring institutions to hold some level of uninsured deposits or subordinated debt. In any case, coverage limits must not be circumvented, uninsured depositors must perceive their deposits to be at risk, and adequate information must be available for accurate assessment of the condition of individual depository institutions.

Maintaining Public Confidence

Before federal deposit insurance, it was possible for a sound financial institution to fail because of sudden, massive withdrawals by depositors who were doubtful about its financial condition. The role of deposit insurance in maintaining public confidence in the financial system may be its most important function. Deposit insurance has been successful in maintaining stability; liquidity crises have not developed even in the case of institutions known to have serious problems.

The recent problems of the savings and loan industry, and so of the FSLIC, reflect the effects of extraordinary interest rate movements on a vulnerable industry. These problems could have been handled with minimal losses to the insurance fund had the FSLIC closed S&Ls when their real net worth approached zero. However, such a policy would have resulted in the closing of nearly every S&L in the country.

Instead, the FHLBB and the FSLIC have followed a more complex strategy that minimized both the number of failures and the cost of resolution. The FSLIC has generally been able to arrange mergers of failing institutions more cheaply than liquidations. As a result, the FSLIC fund has grown despite the increase in failures in 1981, 1982, and 1983. This experience indicates that the size of the fund is more than adequate to handle even severe problems as long as the FHLBB's regulatory powers are used skillfully. More importantly, the recent experience revealed that the powers to arrange mergers and prevent failures are fundamentally more significant than the size of the fund.

The current size of the fund is, of course, inadequate to deal with a drastic deflation and depression of the kind that occurred in the 1930s. It is inefficient and impractical to require that the fund be large enough to cover the losses associated with such a calamity. Such catastrophes are more appropriately a general obligation of the government than of an insurance fund drawn from user fees.

There are a variety of ways by which any perceived inadequacy of the insurance fund could be rectified. There is the traditional regulatory response to increased institutional risk: increased regulation. For example, it would be feasible to regulate the interest rate risk position of S&Ls, perhaps by limiting the maturity of mortgage loans or restricting the use of fixed-rate mortgages.

The adequacy of the insurance fund could be improved by altering the size of the fund relative to its obligations. For example, the level of FSLIC coverage would be reduced (it may be necessary to eliminate the de facto coverage of uninsured depositors created by current FSLIC assistance procedures). Alternatively, the adequacy of the fund could be enhanced by improving the capital adequacy of insured S&Ls. The net worth of S&Ls and the financial resources of the FSLIC fund offer dual protection to savers.

Improving the quality and extent of information on the economic value of S&Ls that is available to the FSLIC would also improve the FSLIC's ability to handle problems. Better information would enable the FSLIC to improve the timing of its actions and the sophistication of its selection of a financial assistance procedure.

The adequacy of the fund could be improved by making premiums risk-sensitive. This would reduce the risk exposure of the fund, rather than supplement the resources available for dealing with failing S&Ls. The level of insurance premiums could also be raised.

The fund's adequacy would increase with certain new management techniques. The FSLIC could reduce the fund's risk exposure, for example, by hedging the risk in financial markets. The currently dominant source of S&L risk is interest rate risk caused by the maturity mismatch of assets and liabilities; the FSLIC could hedge this risk in the debt options market. The fund could also be made more adequate by changing its holdings. If the cash needs of the FSLIC are highest when interest rates rise, the FSLIC should avoid holding long-term securities that would have to be liquidated at a loss to cover assistance needs. The FSLIC has already taken action to reduce the maturity of the fund; a continuation of this policy appears to be warranted.

Despite the success of the past and the ability to increase the size of the fund, it is impossible to be sure that future losses will be within the capacity of the fund. In assessing adequacy, therefore, it is plain that the techniques available to the FSLIC to arrange mergers and prevent failures are fundamentally more important than the size of the fund. More important still is the place and authority of the FSLIC as an entity of the federal government and the government's commitment to maintaining public confidence in depository institutions.

Pricing Risk

In the past few years, increased interest rate volatility, expanded savings and loan association asset and liability powers, and a national preference for deregulation of financial institutions have expanded the risks that may be borne by institutions. The current system of uniform premiums does not discourage risk-taking; regulations have been used for that purpose. Risk-sensitive deposit insurance premiums offer an alternative to regulation as a means of controlling institutions' risk-taking by making such behavior more costly. Risk-sensitive premiums also distribute the costs of insurance more equitably by charging higher premiums to riskier firms. Thus the justification for such a premium structure derives from principles of deregulation, efficiency, and fairness.

A risk-sensitive premium structure varies premiums according to risks that are both measurable and variable. If such a structure is to succeed in deposit insurance, there must be objective, quantifiable measures of risk and the amount of risk must differ significantly (actually or potentially) among institutions. The premium structure need not reflect all types of risk or measure risk perfectly, although such a level of accuracy would be desirable. Risk-sensitive premiums can be both useful and effective as long as the measured risk exposure is directly related to failure, the measurement system provides more accurate risk assessment than the current flat-rate scheme, and the premium structure does not create perverse incentives for institutions to assume types of risks that are not used as a basis for premiums.

There are several criteria for a risk-sensitive premium structure. First, the premium structure should place appropriate relative prices on different types of risk-taking--prices that reflect the relative costs of these risks to the FSLIC. Second, the premium structure should explicitly include the net worth position of the institution because of its ability to absorb losses. Third, the premium structure should be relatively easy to understand. It is critical that managers clearly understand how the premium structure penalizes risk-taking if that system is to discourage such activity. Fourth, the premium structure should minimize the need for supplemental nonprice regulation; the primary purpose of a risk-sensitive premium structure is to provide an alternative to regulation as a means of controlling risks.

Risk-sensitive premiums could be based on the overall risk of an institution as reflected in examination ratings, certain financial ratios, loan losses, earnings, and rate on uninsured deposits. On the whole, however, overall risk indicators are less exact, less reliable, and more difficult and ambiguous to interpret than individual measures of risk. Currently, the most important individual risk derives from interest rate fluctuations: the extent to which the average maturity of an institution's assets exceeds the average maturity of its liabilities. Almost as significant, but less easily measured, is default risk: the risk of losses on loans and investments from default.

Variable-rate premiums should be assessed predominantly on the basis of interest rate risk and default risk, and on real net worth. An insurance premium that rises in proportion to the maturity mismatch of an institution's portfolio will encourage prudent management of interest rate risk. Similarly, if the premium declines as the creditworthiness of the loans and investment increases, the firm will be encouraged to engage in prudent underwriting. In effect, the insurance premiums would emulate the risk-reducing effects of market-determined interest rates, which would rise with poor risk management in the absence of deposit insurance.

For any given level of risk, the liability of the FSLIC is reduced by the amount of an institution's equity shares and pledged deposits. A first step toward making institutions more sensitive to risk is to set insurance premiums in proportion to these two factors--risk and equity.

The Federal Home Loan Bank Board believes that thrift institutions should have the maximum ability to obtain new equity risk capital for their institutions. This capital provides the greatest safeguard to the FSLIC and is the most effective way of ensuring some management accountability. The FHLBB therefore intends to facilitate the ability of mutual institutions that wish to convert to stock form to do so in the easiest and most efficient manner possible.

Further, the FHLBB believes that adequate capital must be maintained in thrift institutions if risk to the FSLIC is to be limited to prudent levels. The existence of risk capital subordinate to the FSLIC guarantee is mandatory if the risk exposure of the FSLIC is to be manageable. The current reporting system, however, does not provide complete information on an S&L's risk or the market value of its equity. The FHLBB is revising the reporting system to improve estimates of each association's condition, particularly in the area of the maturity mismatch of savings and loan portfolios.

The FHLBB believes that the adoption of variable-rate insurance premiums for the insurance offered by the Federal Savings and Loan Insurance Corporation is appropriate. The current insurance structure of charging level premiums based on deposit levels bears no rational relationship to risks imposed on the FSLIC by the insured institutions. Aggressive risk-taking institutions are imposing risk far beyond the level justified by their insurance premiums, while institutions pursuing a less aggressive posture, both financially and in terms of interest rate risk, may be paying excess premiums. The FHLBB believes that a variable-rate insurance premium should be based on the major measurable aspects of risk, including interest rate risk, default risk, and capital adequacy. Implementation of a variable-rate premium should be done over an extended period to allow careful monitoring of its effects.

Expanding Private Insurance

The recent deregulation of financial intermediaries has eroded the ability of federal regulators to control risk directly, as they have in the past. An alternative to regulation is the transfer of all or part of the reliance on the deposit insurance system to the commercial insurance industry. Private insurance should provide incentives to manage risk through premium pricing and other forms of competitive pressure.

Indeed, as a matter of principle, the government should act as an insurer of private depository institutions only if there is a clear public benefit from such insurance that cannot be provided in the private sector. As long as the government provides deposit insurance with uniform and relatively low premiums based solely on deposit volume, not only will the FSLIC's effectiveness continue to deteriorate, but it will also be impractical for private insurers to enter the field. If the federal deposit insurance agencies seek to improve their deteriorating financial performance by pricing and managing their insurance on conventional underwriting principles, then it is appropriate to consider whether it would be more advantageous simply to transfer all or part of the deposit insurance to the private market.

Many sources of depository institution risk are already partly privately insured. The mortgage insurance industry provides protection against a major source of default risk at S&Ls. Fealty and liability insurance provide protection against aspects of management risk. The equity in stock associations is a form of partial self-insurance. Interest rate risk can also be insured, within limits, by hedging the risks in the finanical futures market. Private insurance firms providing comprehensive depository insurance could also hedge their risks in the financial markets.

Three important benefits could result from more comprehensive private deposit insurance. First, private regulation would be substituted, to some extent, for public regulation. Although federal regulation probably would remain the primary source of institutional scrutiny and information, private insurers could be expected to utilize this body of information, as well as their own independent examinations, to develop insurability standards and prices that would create direct economic incentives for institutions to comply with certain standards of prudence. Second, deposit insurance presumably would be priced by the market to eliminate the subsidies or adverse incentives for risk-taking inherent in the current pricing system. Third, greater economic efficiency presumably would be achieved, unintended side effects of government sponsorship would be reduced, and a drain on federal assets (in all but the most severe financial crises) might be forestalled.

Underlying these benefits is the assumption that, unless there is a clear and compelling reason to believe that the market cannot operate effectively, market-oriented pricing and management are inherently superior to government regulation. However, although it seems clear that private insurers could play some role in deposit insurance, total private deposit insurance appears not to be feasible at this time. Some ultimate federal guarantee is essential for public confidence. Moreover, sufficient capacity may not exist in the private market to cover the losses that could accompany a banking panic, severe inflation, or other macroeconomic failures. In any event, the total loss exposure of any private insurer necessarily must be finite and well defined, and this, without a federal "backstop," would be inconsistent with the confidence function of deposit insurances.

Inherent to any joint public-private insurance system is the need for a cooperative relationship between regulators and private insurers during financial crises. It would be necessary to define in advance the types of risks covered by each, as well as the relative rights and powers of the regulators and insurers to enforce capital requirements, extend liquidity, require merger of institutions, and the like. The benefits often attributed to a private insurance program presuppose that the private sector would have substantial authority for underwriting, pricing, and enforcing insurance contracts related to its share of the market. The transfer of such responsibilities may prove to be the most difficult aspect of devising a joint public-private deposit insurance program.

Rethinking Regulatory Structure

The current structure of regulation and insurance developed piecemeal. Depository institutions were first chartered by the states, each of which had its own supervisory authority, and state-run deposit insurance funds date back to the 19th century. A federal role was introduced in the 1860s with the establishment of federally chartered banks under the Comptroller of the Currency. The financial collapse of the 1930s led to the federal chartering and insurance of S&Ls to complement existing state-chartered institutions; federal insurance of commercial banks also arose in the 1930s. A federal chartering authority for credit unions, vested with deposit insurance authority in 1970, appeared later.

The pattern of control that emerged with this long development is summarized in Table F-3, which highlights the substantial duplication of authority. Each type of institution has its own set of regulators. Several agencies typically share responsibility for regulating a particular firm, as in the federal-state oversight of state-chartered federally insured institutions. Also, different agencies perform the same functions for different firms in the same industry, as can be seen in the division of responsibility for national and state member banks between the Comptroller and the Federal Reserve.

The desirability of the current structure of overlapping, parallel, and specialized agencies has been questioned over the years. Duplication implies higher administrative costs and a greater regulatory burden on firms. Shared responsibility among agencies with differing objectives has led to conflict. Broadened asset and liability powers have engendered competition between the banking and thrift industries, highlighting differences in regulation and supervision.

Competitive pressure from the unregulated financial sector has spurred the effort to lessen the regulatory rigidities that hamper the response of banks and thrift institutions. Yet it is unclear whether consolidation would reduce duplication, administrative costs, and regulatory burden. Ultimately, the most significant costs of regulation are not administrative in nature but those associated with inefficiencies in the marketplace caused by financial regulation. It is an evaluation of these effects that must guide consideration of regulatory reform. There are substantive differences between the current system for insuring S&Ls and that for commercial banks. Commercial banks may be influenced by federal government policies in the areas of chartering, insurance, examination and supervision, liquidity, and regulation of activities. At the federal level, these functions are divided among the Federal Reserve System, the Comptroller of the Currency, and the FDIC. For example, federal handling of a failing institution requires coordination by these three agencies, which have different objectives and philosophies. Coordinated action is sometimes slow and difficult to achieve. In contrast, all of these federal functions are provided by a single agency--the FHLBB--for S&Ls. Governmental handling of failing institutions is greatly facilitated by having a single agency with a single approach and objective in charge. Consolidating the insurance functions would destroy this advantage with respect to S&Ls.

Table F-3. Structure of Depository Institution Regulation

Savings and Loan Associations

Function	Federally Chartered FSLIC Insured	State Chartered FSLIC Insured	State Chartered Non-FSLIC Insured
Chartering	FHLBB	State	State
Regulation	FHLBB	FHLBB, State	State
Examination	FHLBB	FHLBB, State	State
Supervision	FHLBB	FHLBB, State	State
Insurance	FHLBB	FHLBB	State
Liquidity	FHLBS, FRS[a]	FHLBS, FRS[a]	FRS[a], FHLBS[b]

Commercial Banks

Function	National Bank FRS Member	State Bank FRS Member	State Bank Non-FRS Member
Chartering	OCC	State	State
Regulation	OCC (FRB, FDIC)	FRB, State (FDIC)	State (FDIC)[c]
Examination	OCC (FDIC, FRB)	FRB, State (FDIC)	FDIC[c], State
Supervision	OCC (FRB, FDIC)	FRB, State (FDIC)	FDIC[c], State
Insurance	FDIC	FDIC	FDIC, State
Liquidity	FRS	FRS	FRS[a]

(continued)

Agencies in parentheses have the authority but do not normally exercise it.

CLF = Central Liquidity Facility
FDIC = Federal Deposit Insurance Corporation
FHLBB = Federal Home Loan Bank Board
FHLBS = Federal Home Loan Bank System
FRB = Federal Reserve Board
FRS = Federal Reserve System
NCUA = National Credit Union Administration
OCC = Office of the Comptroller of the Currency

Table F-3. Structure of Depository Institution Regulation (Continued)

Mutual Savings Banks

Function	Federally Chartered FSLIC Insured	Federally Chartered FDIC Insured[d]	State Chartered FDIC Insured	State Chartered Non-FDIC Insured
Chartering	FHLBB	FHLBB	State	State
Regulation	FHLBB	FHLBB, FDIC	State	State
Examination	FHLBB	FHLBB, FDIC	State, FDIC	State
Supervision	FHLBB	FHLBB, FDIC	FDIC (State)	State
Insurance	FHLBB	FDIC	FDIC[e]	State
Liquidity	FHLBS, FRS[a]	FHLBS, FRS[a]	FRS[a], FHLBS[b]	FRS[a], FHLBS[b]

Credit Unions

Function	Federally Chartered NCUA Insured	State Chartered NCUA Insured	State Chartered Non-NCUA Insured
Chartering	NCUA	State	State
Regulation	NCUA	State (NCUA)	State
Examination	NCUA	State (NCUA)	State
Supervision	NCUA	State (NCUA)	State
Insurance	NCUA	NCUA	State/none
Liquidity	CLF[b], FRS[a]	CLF[b], FRS[a]	CLF[b], FRS[a]

[a] For institutions offering transactions accounts, as provided by Depository Institutions Deregulation and Monetary Control Act of 1980.

[b] If member.

[c] If insured by the FDIC.

[d] Mutual savings banks that convert to federal charter may retain FDIC insurance.

[e] Insurance of accounts over $100,000 at FDIC-insured Massachusetts mutual savings banks provided by state.

Source: Federal Home Loan Bank Board.

Another major problem arising from the consolidation of the insurance funds results from the substantive differences among S&Ls, commercial banks, and credit unions. Despite S&Ls' broadened asset and liability powers, substantial differences among these three industries will persist for many years, and specialized institutions will continue to constitute the bulk of these industries. Insurance risks, regulatory status, and assistance techniques are quite different for each industry. It is unlikely that consolidation of insurance funds would eliminate much duplication; it would primarily consolidate a number of diverse activities in one agency.

Therefore, consolidation of the insurance fund should not be initiated without first rationalizing the functions of the financial regulators. The FHLBB believes that it currently has a highly efficient regulatory mode, incorporating under its auspices many of the functions that three separate agencies--the Federal Reserve, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation--now perform for commercial banks.

SECTION I

RESPONDING TO CRISES

(307)

The history of financial institution legislation in the United States is largely a record of Congressional response to crises. Government intervention in the marketplace was limited as long as the market was perceived to work well on its own. However, a sequence of three crises spawned the major banking and thrift legislation that has shaped the regulatory structure for all depository intermediaries in the United States today. The crises occurred in the 1860s, in 1907, and during the Great Depression of the 1930s. The circumstances surrounding each historical episode were as different as the methods chosen by Congress to correct the problems. It was not until the banking system virtually collapsed in the 1930s that Congress implemented a system of government insurance for depositors in financial intermediaries, thereby intricately involving the government in the operation of virtually all depository institutions in the country. This system of deposit insurance has remained largely intact since that time. Although there have been periods of recession and financial difficulties since, only recently has the viability of the existing system been seriously questioned.

The high and volatile interest rates experienced over the past few years have resulted in substantial losses for many financial intermediaries. The current crisis is centered in the thrift industry, where the cumulative impact of national housing policy and thrift regulation have left the majority of these institutions highly vulnerable to such interest rate movements. Recent losses are the result of an asset-liability structure that has evolved over a 40-year period of stable interest rates. Most thrift institution balance sheets currently reflect a combination of long-term fixed-rate assets and relatively short-term market-rate deposit liabilities. Under such an asset-liability structure, rising interest rates increase the cost of funds more rapidly than the yield on assets. During 1981-1982, the cost of funds at many of these institutions exceeded the yield on their assets, causing severe losses and a significant erosion of net worth. In that period 800 thrifts were merged or liquidated, and over 200 of these consolidations required government assistance or concessions.

Although the viability of a large number of financial institutions is questionable, the current crisis has not been characterized by a loss of depositor confidence or industrywide liquidity problems. The existence of deposit insurance has prevented these events from occurring. Government deposit insurance and the regulatory system have effectively eliminated the risk associated with depositing funds in financial intermediaries. Individuals no longer differentiate among depository institutions based on safety and soundness but rather on rate of return and service. Consequently, market forces are mitigated that would otherwise dictate prudent risk management behavior within individual associations.

It is precisely the absence of these market forces that enabled the thrift industry to operate under the restrictions dictated by national housing policies. To a large extent, deposit insurance transfers the risk associated with the operation of depository institutions from depositors to the federal government. To compensate for the resulting reduction in market discipline, a regulatory structure has evolved that implements restrictions and procedures designed to manage various aspects of risk. However, gradual persistent inflation, changing markets, and growing competition within the financial sector have highlighted the current system's inadequacy.

Congress recently responded to these extensive changes by enacting two major pieces of legislation--the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Depository Institutions Act of 1982. These two laws fundamentally changed the nature and competitiveness of depository institutions. However, this legislation does not address the extensive risk the government has assumed under its insurance and regulatory system. While deregulating depository institutions may enable them to be more competitive, it significantly broadens the government's exposure to risk. Thus it is appropriate to reexamine deposit insurance in light of these recent changes. The historical development of the current deposit insurance system is reviewed in detail in the following discussion.

HISTORICAL PERSPECTIVE ON THE EVOLUTION OF DEPOSIT INSURANCE

The evolution of the deposit insurance system is reflected in the history of commercial banking regulation. This history is important for an informed appraisal of the contemporary insurance system for savings and loan deposits and is especially applicable to savings and loan associations (S&Ls) subject to the new powers provided in the Garn-St Germain legislation of 1982.

It may be argued that a system of federal deposit insurance was enacted in the United States as a last resort. Other mechanisms that had been used to maintain stability and prevent loss of depositor confidence had simply not worked. In the nation's early years, the federal government maintained a laissez-faire attitude toward financial markets. This situation prevailed until 1864 when Congress enacted the National Bank Act, which established the Office of the Comptroller of the Currency. Nearly 50 years later, the Federal Reserve Act became law, and the country had its first central bank in 1913. In 1933 Congress fundamentally altered the relationship of the government to depository institutions by creating federal deposit insurance agencies for commercial banks and savings and loan associations. This legislation was a response to the perceived failure of the central bank to prevent a virtual banking collapse during 1933. To understand how and why the country was gradually persuaded to adopt a system of deposit insurance, it is necessary to understand why the mechanisms that existed prior to 1933 failed, or at least why they were perceived to have failed.

Commercial Banking in the United States Before 1930

The commercial banking system that existed in the United States prior to 1864 involved virtually no regulation by the federal government. In addition, the federal government did not issue a national currency; individual commercial banks were chartered by the states in which they operated and issued their own notes. All commercial banks promised to redeem their notes in gold at a fixed price. These notes constituted the available currency and there was a strong incentive for individual depositors to scrutinize the activities of the bankers with whom they dealt.

The National Bank Act was initiated in 1864 with the immediate purpose of creating a system to facilitate the financing of the Civil War. This act instituted a system of nationally chartered commercial banks and altered the strictly private relationship between depositor and bank. To administer this system, the Office of the Comptroller of the Currency was created and empowered to regulate the note issues of national commercial banks and to establish reserves requirements. The most notable accomplishment of the National Bank Act was the elimination of competing notes issued by state banks and the indirect establishment of a national currency. However, this act did not create a central bank or a government lender of last resort, nor did it place the government in the position of bearing a part of the risk that is involved in the relationship between a depositor and a commercial bank.

The system of bank regulation that was established in 1864 remained essentially intact until 1913. The next impetus for change in the system was the Panic of 1907, which was one of the more severe of a number of so-called financial panics or liquidity crises that occurred during the latter decades of the 19th century. The essence of a liquidity crisis was an actual or potential run on a bank, in which depositors would demand withdrawal of funds. The available methods for dealing with a run were for one commercial bank to borrow notes from another, or for a commercial bank to liquidate assets to obtain notes to satisfy depositors. While the National Bank Act incorporated a provision that required commercial banks to hold reserves for such contingencies, these reserves were held in the form of deposits with other commercial banks and were often pyramided in the large money-center banks. Hence the system relied on the willingness and ability of the large money-center banks located in major cities to provide liquidity to smaller banks spread throughout the country. The Panic of 1907 reflected the participants' beliefs that the ability of large commercial banks to provide liquidity was strained to the limit. In that year Congress called for a study of the problem that led to the Federal Reserve Act of 1913.

The Federal Reserve Act established a central bank that would serve as lender of last resort, control the volume of reserves in the banking system, and regulate the issuance of currency. Although the Federal Reserve Act established a government lender of last resort, it did not obligate the federal government to act as a guarantor or insurer of private depository institutions. It empowered the Federal Reserve, as an independent entity, to decide under what terms and to what extent it would lend to commercial banks. Thus an independent governmental organization was given discretion as to what sort of policy it would pursue in times of distress. In retrospect, it appears to be a failure by the Federal Reserve to interpret broadly its mandate to act as a discretionary lender of last resort that led to the creation of a deposit insurance system in 1933.

The Banking Crisis of the Early 1930s

In 1933 a national "holiday" was declared by President Franklin D. Roosevelt for commercial banks in the United States. This holiday, when no banking activities took place, was the culmination of a crisis that had developed over the previous two and one-half years. A crisis such as this was not an unusual event in American financial history; however, in none of the previous episodes had bank failures occurred on such a scale. Between 1930 and 1933 approximately

9,000 commercial banks suspended operation--nearly half of those in operation at the beginning of 1930.

In late 1930 the failure of more than 600 commercial banks created a general sense of financial panic throughout the country, and for the first time in many years there was a significant movement to convert demand deposits into currency. The crisis continued as a large number of additional banks failed in 1931. Public confidence declined further and commercial banks that were still solvent took action to improve their liquidity. Banking failures became more widespread throughout 1932. On March 6, 1933, two days after his inauguration, President Roosevelt proclaimed a bank holiday in which even the Federal Reserve suspended its operations. Congress quickly passed the Banking Act of 1933; the process of restoring confidence in the financial system had begun.

It has been argued by Friedman and Schwartz (1963) that the banking crisis of the 1930s could have been avoided if the Federal Reserve had provided adequate liquidity to the banking system. The crisis of public confidence and withdrawal of deposits compelled commercial banks to liquidate assets simultaneously, and the forced liquidation in a depressed market resulted in severe losses and commercial bank failures. Had liquidity been provided by the Federal Reserve, the ultimate losses would have been significantly reduced.

It appears that the principal reason liquidity was not forthcoming lies in the Federal Reserve Board of Governors' perception of the nature of the crisis. It is difficult to escape the notion that the failure of the Board of Governors to deal effectively with the situation was a failure of individuals more than a failure of the system. More appropriately, it was the failure of a system with discretion as its critical element. The central banking system established in 1913 empowered the Federal Reserve not simply to manage the liquidity of the banking system, but also to decide the appropriate distribution of financial risk between the private financial system and the government. Had the Federal Reserve provided more liquidity to commercial banks, the losses incurred by both the banking and savings and loan industries would certainly have been smaller than those that actually developed, and the Depression would have been less severe. However, the financial responsibility for potential losses would have been transferred, in part, from depositors and other commercial bank security holders to the Federal Reserve system. Apparently, the Board of Governors of the Federal Reserve did not conceive of themselves as being responsible for accepting that risk.

Impact on the Savings and Loan Industry

The crisis that afflicted the savings and loan industry in the early 1930s was substantially different from the one experienced by commercial banks. Savings and loan associations did not offer transactions accounts as did commercial banks, and they were not subject to the regulation of the Comptroller of the Currency or the Federal Reserve. They did not experience what was for commercial banks principally a liquidity problem generated by the widespread conversion of demand deposits to cash. Instead, S&Ls faced the serious problem of a large number of mortgage defaults. From 1930 to 1934 S&Ls experienced a foreclosure rate on mortgage loans of approximately 14.0 percent, measured as a portion of the total dollar amount of loans outstanding, while commercial banks experienced a rate of 6.4 percent. Because savings and loan portfolios were almost exclusively composed of mortgages, this constituted a crisis for the industry. From 1930 to 1933 the size of the industry declined by 25 percent. The industry contracted an additional 15 percent between 1933 and 1939.

The Advent of Deposit Insurance

The financial crisis of the early 1930s spawned legislation that fundamentally changed the financial intermediation industry in the United States. This legislation ended the period of complete reliance on the discretion of the Federal Reserve Board. The key legislative action pertaining specifically to commercial banks was the Banking Act of 1933. The 1933 act created the Federal Deposit Insurance Corporation (FDIC) and required all federally chartered banks to become members. Within a short period of time, nearly all commercial bank deposits were insured by this agency.

The financial crisis of the 1930s also generated a federal regulatory system for S&Ls that has existed largely intact since that time. The legislation responsible for this system includes the Federal Home Loan Bank Act of 1932, the Home Owners' Loan Act of 1933, and the National Housing Act of 1934. The 1932 act established a system of 12 district federal home loan banks and the Federal Home Loan Bank Board (FHLBB) to provide liquidity to S&Ls. The 1933 act extended the powers of the FHLBB to include the chartering and regulating of S&Ls. The 1934 act created the Federal Savings and Loan Insurance Corporation (FSLIC) to provide deposit insurance for the savings and loan industry similar to that provided for commercial banks. For the first time, this legislation created roughly comparable regulatory systems for both commercial banks and S&Ls.

Housing Policy and the Creation of the FSLIC

Today savings and loan associations are generally recognized as a specialized type of banking institution with a financial intermediation function similar to that of commercial banks. Consistent with this perception, current monetary policy and consumer protection legislation has applied uniformly to both industries. However, this has not always been the case. As reflected in the preceding discussion on the creation of the FDIC, regulatory schemes affecting commercial banks in the 19th and early 20th centuries focused on, and responded to, the central role of that industry in the nation's monetary system. In contrast, the savings and loan industry was completely excluded from the federal chartering and liquidity laws adopted in 1863 and 1913. When Congress eventually developed a regulatory program for the savings and loan industry in the 1930s, it was in response not to monetary considerations but to a strong national policy to foster home ownership.

Beginning with the Oxford Provident Building Association, established in 1831, each savings and loan association organized in the 19th century was based on the concept of cooperation among members of a mutual association. These institutions existed for the sole purposes of encouraging thrift and financing ownership of members' homes.

In light of the limited purposes of savings and loan associations in the 19th century, it is understandable that they were not the target of federal regulations relating to monetary policy. When a system for federal chartering of banking institutions was created in 1863 for the purpose of establishing a national currency, there was no need to include S&Ls because they did not issue bank notes used as currency. Furthermore, S&Ls were not involved in the financial panics in the 19th and early 20th centuries that led to the creation of the Federal Reserve System as a central liquidity facility. Those crises were due largely to a concentration of interbank deposits in money-center banks; the limited purposes and investment practices of S&Ls prevented their participation in this activity. Finally, S&Ls were not true depository institutions during this period. An individual member's investment in an association was represented by an equity interest, not a debt obligation, and these "shares" had long-term maturities, in many cases exceeding 12 years. Thus the demand deposit, a basic element of the money supply, had no parallel in the savings and loan industry, and S&Ls were not involved in the money-creating function that was the focus of reserve requirements and other monetary regulations.

When Congress' attention ultimately turned toward the savings and loan industry, it was due to the primary role of these institutions in the provision of home mortgage credit. Following World War I the nation faced a major shortage of housing, especially in urban areas. As early as 1919 a bill was introduced in the Senate "to Create a Federal Home Loan Board and Home Loan Banks for the Purpose of Aiding and Financing the Construction of Homes." This and subsequent bills culminating in the Federal Home Loan Bank Act of 1932 were intended to establish a central, wholesale lending facility that would provide a secondary source of home mortgage credit.

In the 1930s the focus of national housing policy shifted from the financing and building of new homes to the plight of existing home owners. At the worst of the Great Depression, almost half of the mortgagors on urban owner-occupied homes were in default. To remedy this problem, the Home Owners' Loan Act of 1933 authorized the Home Owners' Loan Corporation to acquire and refinance individual home owners' mortgages, and it authorized the Federal Home Loan Bank Board to charter federal savings and loan associations. The latter provision was adopted in recognition of the fact that one-third of the counties in the nation did not have any home mortgage lending institutions.

The creation in 1934 of a government-sponsored corporation, the FSLIC, to insure accounts at S&Ls was also related more closely to housing than monetary policy. In spite of the success of the Home Owners' Loan Corporation in reducing mortgage defaults, the combination of depressed real estate values and a high mortgage delinquency rate significantly depreciated S&L mortgage portfolios, causing a decline in public confidence in these institutions. To provide the same type of security available to bank depositors in the form of FDIC insurance, Congress established the FSLIC through title IV of the National Housing Act. The circumstances surrounding this legislation contrast markedly with those relating to the FDIC legislation. It has been suggested earlier in the discussion that the underlying risk of the assets in commercial bank portfolios was not excessive in 1933 and that, instead, it was the banking crisis itself that compelled banks to liquidate assets simultaneously, with resulting losses. Thus the primary purpose of FDIC insurance was to stem the radical withdrawal of funds or disintermediation that threatened the survival of the commercial banking industry. In contrast, the long-term maturities of savings and loan shares prevented the type of run that ruined commercial banks in this period. The threat to S&Ls thus was not that disintermediation would cause losses, but that a lack of public confidence might prevent an adequate inflow of new funds to maintain mortgage lending activities. The history of the FSLIC legislation and its placement in the National Housing Act suggest that Congressional concern lay more in stimulating additional home mortgage credit through increased capitalization of S&Ls than in preventing the demise of these institutions.

THE CURRENT CRISIS

The regulatory system for depository institutions in the United States remained largely unchanged from the 1930s until passage of the deregulation legislation of the early 1980s. This system worked extraordinarily well in a relatively stable economic environment where it was possible to maintain segmented and specialized financial institutions. Few serious problems surfaced until inflation began to accelerate in the 1970s. This regulatory system was not designed for an inflationary environment, and it has not fared well in the past decade. To understand the recent difficulties, it is necessary to review how the system worked during the preceeding period of stability.

Thirty Years of Stability: 1935-1965

To a large degree, since the financial reform legislation of the 1930s was enacted, all depository intermediaries have been regulated in much the same manner. The economics of the market for deposits demanded this. As has become apparent with the recent experience with money market funds, if one class of financial institutions is granted too much of a comparative advantage, other classes of institutions will be driven out of the marketplace for consumer savings. Hence the regulation of commercial banks and S&Ls has always centered on a debate about the magnitude of the advantage that might be conferred on each type of institution.

Since the National Housing Act of 1934 became law, S&Ls have been regulated in such a way as to promote the development of residential housing. This has meant that S&Ls have been compelled to be specialized financial institutions, yet their competitive position vis-a-vis commercial banks has had to be maintained. Efforts in this direction have resulted in a savings and loan industry with an asset portfolio of long-term fixed-rate mortgages and relatively short-term deposit liabilities. Consequently, savings and loans derived their profits from the spread between long- and short-term interest rates. Aside from loan origination and servicing fees, this has been their only real source of revenue. This vulnerable revenue structure was not developed by the private marketplace. Rather, the portfolio composition and resulting profit position of S&Ls are largely a result of the regulatory system maintained during the postwar period. The key to the success of this system was the maintenance of what is termed a "normal" yield curve, which occurs when long-term interest rates are above short-term interest rates. It was widely believed that with relatively stable interest rates, the normal yield curve should prevail due to individuals' preference for liquidity. This theory does not imply that the spread between long- and short-term interest rates will remain constant or even positive at all times. It does imply that, on average, a positive spread between long- and short-term rates will exist.

Rational private entrepreneurs would be willing to operate an S&L under such constraints only if they believed that a normal yield curve would persist. Furthermore, deposit insurance effectively transferred the risk associated with a persistent negative interest-rate spread to the government insurance agency, the FSLIC. Savings and loan managers ran their institutions with the knowledge that the government was essentially responsible for the slope of the yield curve and for the insurance behind their institutions. Over the 30 year period from 1935 to 1965, interest rates were relatively stable, the yield curve had a normal slope, and the savings and loan industry prospered.

The Significance of "Regulation Q"

Savings and loans and their regulators faced a serious dilemma resulting from the enforced mismatch of maturities that has characterized these depository intermediaries. If the profitability of the industry is to be maintained, S&Ls cannot be forced to compete for savings capital when short-term interest rates are rising and the cost of those funds is increasing. However, if they do not compete then they must curtail new lending and search for alternative, presumably less costly, ways to continue to fund existing loans.

The initial solution to this problem chosen by the Congress and implemented by the regulatory authorities was to restrict the ability of all insured depository institutions to compete for consumer deposits on the basis of interest rates. The government chose to place ceilings on the interest rates that S&Ls and commercial banks could pay to depositors and to regulate competition between these two classes of institutions by awarding S&Ls a somewhat higher ceiling rate. Although separate regulations applied to commercial banks and S&Ls, these interest rate ceilings have come to be known as "Regulation Q," which specifically refers to the interest rate regulations of the Federal Reserve.

It has long been recognized that Regulation Q ceilings were an ineffective and inequitable means for stabilizing the flow of funds into depository institutions, particularly S&Ls. Recommendations were made in both the President's Commission on Financial Structure and Deregulation (1971) and the Congressional study of financial institutions and the nation's economy (1976) to alter the existing system. By the late 1960s or early 1970s, it was apparent that the volatility of interest rates was threatening the viability of the entire system for housing finance in the United States.

The Impact of High and Volatile Interest Rates

Soon after the extension of interest rate ceilings to the savings and loan industry, both commercial banks and S&Ls were faced with disintermediation, or the radical withdrawal of funds. This disintermediation was the result of the conflict between consumer attempts to hedge a rising inflation rate and the regulatory system that restricted interest rates on deposit accounts. In the 1960s and 1970s, there were at least three serious bouts of disintermediation. These did not involve actual net outflows of funds from S&Ls; however, they did result in a serious deterioration in the rate of inflow of savings.

In 1978 rising interest rates and fear of disintermediation brought pressure on the regulatory agencies and Congress to allow depository institutions to compete for funds on the basis of interest rates. Facing the prospect of a more serious disintermediation problem than any that had been experienced to date, the regulators granted the depository intermediaries significant new authority in June of that year. Specifically, commercial banks and S&Ls were allowed to offer money market certificates in minimum denominations of $10,000 at rates slightly above the prevailing six-month U.S. Treasury bill rate. These accounts became enormously popular, and one year after their introduction 20 percent of all savings deposits at S&Ls were in the six-month money market certificates.

This change was particularly significant because it ended the period when the federal regulators protected the earnings of S&Ls by regulating the cost of their deposit accounts. Without these expanded powers to compete for funds, S&Ls faced the prospect of massive outflows from savings accounts. However, with such powers they faced the prospect that their cost of funds could escalate rapidly, while the return on their long-term mortgage portfolio lagged far behind. Unfortunately, interest rates continued to rise over the next three years, reaching record levels. Savings and loans' cost of funds quickly exceeded their yield on assets resulting in significant losses and many S&Ls faced insolvency.

Technological Change and Market Innovations

The current regulatory system still reflects the segmented market structure for financial institutions that was the emphasis of the 1930s legislation. The broadest distinctions are between insurance companies, securities firms, and depository institutions. Each of these three classes of institutions is defined to be in distinct lines of business and is regulated in widely different ways. In the 1930s insurance companies were already largely separate from other financial firms and were regulated at the state level. Insurance companies never faced a crisis severe enough to lead to a federal regulatory system, and they were largely ignored as regulatory reform was imposed on other financial institutions. The current separation between investment companies and depository institutions was a result of the financial reform legislation of the 1930s. In addition, a distinct regulatory system for the securities industry was instituted in the Securities Acts of 1933 and 1934. Such market segmentation went unchallenged for 40 years; however, historically high interest rates and recent technological developments have nurtured increasing innovation in financial markets.

Tremendous decreases in the cost and resultant increases in the versatility of computer technology have substantially altered the cost of providing financial services. At the same time the development of improved communications technology has made it possible for a single financial institution to serve a widely dispersed geographic market. This decrease in the underlying cost of providing financial services has created economies of scale.

Many financial services are now most efficiently provided through mass production. Consequently, the distinctions between classes of institutions and the markets they serve are becoming more and more arbitrary. Institutions that are regulated in distinctly different ways under different laws now use essentially the same technology and production processes to deliver what have become extraordinarily similar financial services.

In the past decade, a wide variety of new financial instruments, as well as markets for trading these instruments, have been created. Among the most important yet complicated financial innovations are the markets for interest rate futures and for options on securities. These new markets provide additional opportunities for redistributing risk throughout the economy. In addition, during the 1970s a large and sophisticated secondary market for mortgages developed and the money markets became significantly more diverse. More sophisticated cash-management techniques have become commonplace tools of corporate financial managers.

All of these changes have substantially added to the challenge facing small and segmented firms that seek to provide financial services. Financial institutions and their regulators must face the important question of the extent to which traditional market constrains are obsolete. As regulatory restrictions are eroded, regulatory agencies are faced with responsibility for a broader range of financial activities and, consequently, the management of increased risk. These issues also play a central role in the reevaluation and restructuring of deposit insurance.

OUTLOOK FOR THE SAVINGS AND LOAN INDUSTRY

The recent crises facing the thrift industry highlighted the inadequacy of the regulatory structure for depository institutions and prompted further legislative action. The changes in the regulatory system for depository intermediaries that were incorporated in the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Depository Institutions Act of 1982 constitute a significant change in the market environment for savings and loans. It is not obvious what will be the ultimate impact of these changes in the regulatory system for depository institutions. These regulatory changes have decreased the barriers that have segmented commercial banks from S&Ls. They have also relaxed the constraints that were imposed on managers of S&Ls regarding the composition of both the asset and liability sides of their balance sheets. There is now a much greater opportunity for managerial capabilities to be reflected in performance. However, these changes do not guarantee the savings and loan industry a bright future. Rather, the regulatory changes have given S&Ls new powers to compete in the market for financial services, while the decline in interest rates has provided a respite in which they can

---

DEPOSITORY INSTITUTIONS DEREGULATION AND MONETARY CONTROL ACT OF 1980

(Public Law 96-221, 94 Stat. 132 (1980))

- Requires reserve requirements for transaction accounts and nonpersonal time deposits at thrift institution members of the Federal Home Loan Bank System
- Establishes Depository Institutions Deregulation Committee (DIDC) to phase out deposit rate ceilings by 1986
- Authorizes interest-bearing checking accounts for individuals and nonprofit customers of thrifts
- Authorizes federally chartered S&Ls to undertake commercial real estate loans, consumer loans, and investments in commercial paper and corporate debt securities (up to 20 percent of assets)
- Authorizes credit card lending for federal S&Ls
- Authorizes trust activities for federal S&Ls

GARN-ST GERMAIN DEPOSITORY INSTITUTIONS ACT OF 1982

(Public Law 97-320, 96 Stat. 1469 (1982))

- Deregulates federal savings and loan association activities:
  - --Authorizes demand deposits for business customers
  - --Eliminates restrictive loan-to-value ratios on residential mortgage loans
  - --Authorizes commercial real estate loans (up to 40 percent of assets)
  - --Increases authority for investment in commercial paper and corporate debt securities (up to 100 percent of assets)
  - --Authorizes a new money market deposit account to compete with money market funds
  - --Increases authority for consumer loans (up to 30 percent of assets)
  - --Authorizes personal property leasing (up to 10 percent of assets)
- Authorizes the FSLIC to purchase net worth certificates as a means of assisting associations experiencing losses and low net worth
- Preempts state law prohibitions of due-on-sale clauses and alternative mortgage instruments
- Authorizes de novo federal stock associations
- Authorizes federal chartering of FDIC insured savings banks and permits federal S&Ls to convert freely to savings bank charter

---

position themselves for this competition. Those that are not prepared to compete in the next decade will not survive.

The most important new competitive pressure that S&Ls will face in the next few years may well be in their asset structure. In the past, S&Ls have been compelled to invest almost exclusively in long-term fixed-rate mortgages. Now they have the authority to choose what type of mortgages to offer and they must choose mortgages that are competitive. Yet, in late 1982 the competition came principally from purchasers of mortgages in the secondary mortgage markets, and they were purchasing long-term fixed-rate mortgages. Investors that have much longer maturity liabilities than savings and loan associations--life insurance companies for example--can acquire long-term fixed-rate mortgages without being exposed to as much risk as would an S&L. As long as S&Ls continue to offer liabilities with short maturities and long-term mortgages with fixed rates, both they and the FSLIC will be exposed to substantial interest rate risk. Yet, if they refrain from offering long-term fixed-rate mortgages when other investors with long-term liabilities are willing to buy them, they will lose their market share.

While S&Ls may face new competition in their traditional mortgage lending business, many will simultaneously attempt to be new competitors in the markets for commercial and consumer lending. The powers afforded S&Ls in the recent deregulation legislation make it possible for them to diversify their lending activities.

No longer will they be compelled by regulation to be exclusively mortgage lenders. However, without changes in their tax treatment a substantial diversification of their portfolios may not be practical. Even with a change in the tax laws affecting S&Ls, these new lending powers do not represent a panacea. Both the commercial and consumer lending markets are already very competitive. Savings and loans have no particular expertise in these markets and no particular comparative advantage vis-a-vis commercial banks and finance companies that already serve them. The same is true in the securities brokerage industry--an industry that is attracting new competition from both banks and S&Ls.

The competition that will emerge presents the FSLIC with a new set of problems. As this competition develops, the FSLIC must protect itself as well as depositors in insured institutions. Moreover, it must seek to control risk-taking by managers of insured institutions without the kind of direct regulatory constraints that have been available in the past.

Recent legislation has not required any significant changes in the availability or the price of deposit insurance. While S&Ls and commercial banks are free to compete in ways that were previously foreclosed to them and S&Ls have been granted substantial new powers, depositors remain protected from any increased risk that these changes might generate. Moreover, that protection is provided without any change in the price charged to insured institutions.

The regulation and insurance of depository institutions by the government are not activities that can be easily separated. Once an institution is insured by the government--or by an agency of the government--then it is necessary for the government to regulate the activities of the insured institution to limit the risk to which it is exposed. While all regulatory efforts are not successful in reducing risk, depository institution regulation should be designed to be compatible with the system of deposit insurance.

In the relationship between deposit insurance and regulation, deposit insurance is a valuable asset for individual depository institutions. Yet the price they pay for that asset is not simply the premium charged for insurance; it also includes all the costs imposed on the institution by the regulatory system. If the cost of the insurance--i.e., the regulatory system--is too large, institutions will seek a way to avoid those costs. The recent explosive growth of money market funds represents a very successful example of an attempt to escape that cost. However, if the cost imposed by regulation and insurance premiums is very low, then deposit insurance will become very attractive to institutions that sell financial services. The implication is that deposit insurance has a market price, and if the actual price of insurance is set either too high or too low, this will have a significant impact on financial markets.

One of the most important aspects of the recent deregulation legislation, therefore, is the viability of the deposit insurance system. Has the risk facing the system been increased or decreased? As it now stands, is the price for deposit insurance too high or too low? These broad questions and the more specific and detailed questions to which they lead are the focus of this report.

The Commitment to Housing as Social Policy

Savings and loans have historically served the long-standing social policy of promoting home ownership. That policy has been supported by virtually every Congress and every administration since the 1930s. Home ownership is now threatened, however, by inflation and the high interest rates it has generated. The cost of a home and the accompanying financing have increased dramatically. Existing home owners have been the beneficiaries of this inflation in home prices. Savings and loan associations and first-time home buyers have been its victims. A substantially deregulated and diversified savings and loan industry will cease to be the special conduit for home-ownership financing that it has in the past. Inevitably, this means that either reforms to increase private market participation in mortgages must be made or other subsidies for home ownership will be necessary to maintain the national commitment to housing.

If S&Ls are to evolve into more diversified financial service firms, then it is important to reassess the fundamental motivation for insuring these institutions. Savings and loans were originally provided with such a system to maintain parity with commercial banks. Had S&Ls been forced to compete with commercial banks without the benefits of an insurance system during the financial crisis of the 1930s, they almost certainly would not have survived. From the standpoint of social policy, the central reason their survival was important was that they constituted a critical element in the housing finance system. Therefore, insurance became a necessary part of national housing policy.

As developed in some detail earlier in this section, commercial banks were insured by the government in order to maintain the viability of the system of exchange in the economy. The social cost of failure of the banking system, and therefore of the system of exchange, was judged to be sufficiently high that a federally guaranteed insurance system was warranted.

The issue of which institutions should and should not be insured in a highly diversified financial services industry is difficult to resolve. As S&Ls become more diversified, the original reason for insuring them loses its significance. However, if in the process of diversification, they become an integral part of the transactions or exchange process, then the reason for insuring them is the same as the reason for insuring commercial banks. If virtually all financial service firms engage to some extent in managing transactions accounts, then there is at least some justification for insuring all such institutions.

The extent to which insurance may be extended across a wide class of financial institutions depends on the features of the insurance system itself. An important issue is whether insurance relates only to specific classes of accounts or to the entire institution. Savings and loan associations have traditionally had a small volume of uninsured deposits and there was little practical distinction between insuring deposits and insuring the institution. However, as institutions become far more diversified it may be appropriate to restrict the scope of deposit insurance.

Deregulation vs. Reregulation

It is often argued that changes in the marketplace force regulatory change. This was almost certainly the case with recent deregulation of financial institutions. However, financial institutions were originally regulated for the reasons discussed in this section: controlling the risk associated with depository institutions' actions or promoting public policy. In the future insurance agencies must limit risk through regulations that constrain the activities of insured institutions or through pricing mechanisms that provide proper incentives for risk-taking. If neither option is available, then the insurance agency is exposed to considerable risk.

Although the deregulation of the past few years was a necessary response to marketplace innovations, it has also substantially limited the ability of regulatory agencies to constrain the risk-taking of insured institutions. Moreover, this has occurred at a time when there are a number of insured institutions that are operating with impaired capital and have strong incentives to engage in very risky investments. In light of the competitive pressures that the industry will face in the next few years, this deregulation could result in substantial losses. If no attempt is made to deal with these potential problems, there could be substantial pressure for renewed regulation of depository institutions. As a result, it is exceedingly important that the insurance system be revised where appropriate to encourage the growth of a healthy and economically efficient financial services industry throughout the remainder of this century.

SUMMARY

The savings and loan industry was not regulated until the financial crisis of the 1930s. In 1933, Congress altered the relationship of government to depository institutions by creating federal deposit insurance and financial regulatory agencies. Contrasting to federal deposit insurance for commercial banks, which was established for the purpose of stemming radical disintermediation, savings and loan deposit insurance was established to protect the industry from the high rate of mortgage defaults during the Great Depression and to support the national policy of fostering home ownership.

The regulatory system created as a response to the crisis of the 1930s remained largely intact until very recently. It worked well until accelerating inflation began in the 1970s. The 30 years between 1935 and 1965 were a period of interest rate stability during which S&Ls remained profitable because, overall, long-term interest rates were higher than short-term interest rates. During the 1970s, increased inflation led to a serious decrease in the rate of inflow of savings at S&Ls, which led to a concern about the availability of funds for housing, and interest rate risk became a central concern of financial institutions.

During the past decade, tremendous decreases in the cost and increases in the versatility of computer technology altered the cost of providing financial services. Additionally, a wide variety of new financial instruments and new markets for trading them have been created. The regulatory reform legislation passed by Congress in the early 1980s decreased the barriers that previously segmented S&Ls from commercial banks and relaxed the constraints that were previously imposed on managers of S&Ls regarding the composition of both assets and liabilities. This legislation has not required any significant changes in the availability or the price of deposit insurance. As S&Ls evolve into more diversified institutions, it is necessary to reassess and revise the insurance system to encourage the growth of a healthy and economically efficient financial services industry, and to reassess the role of S&Ls in national housing policy.

SECTION II

REPLACING DIRECT CONTROLS

(343)

Over time, federal deposit insurance coverage in the United States has been raised in increments from its original level of $5,000 to its current limit of $100,000 per deposit account. Despite these increases, 100 percent coverage of all deposits has never been a continuing feature of this system. Limited coverage is consistent with the objective of protecting small depositors. But the principal reason for limited coverage is that the presence in the market of large uninsured deposits leads institutions to compete for those deposits on the basis of safety and conservatism.

Managing the risk exposure of the Federal Savings and Loan Insurance Corporation (FSLIC) is not a new concern. Since its inception, the FSLIC (and Congress) has taken a variety of actions to control risk-taking by savings and loan associations (S&Ls). Such actions include net worth requirements, regulatory limits on permitted activities, the dollar limit on insurance coverage, assistance methods used to deal with failing firms, accounting requirements, regulations affecting market structure (chartering, branching, etc.), deposit interest rate ceilings, and examinations. The dominant theme of these past actions is regulatory restriction.

In recent years, there has been a growing preference and need for the deregulation of depository institutions as well as other types of businesses. Regulatory restraints on S&L risk-taking have been significantly eased. This is not to say that all deregulation has increased the risk exposure of the FSLIC; on the contrary, much of the deregulation to date has been beneficial, permitting associations to fare better in an increasingly competitive marketplace. However, there has been an overall decline in the willingness and ability of government regulators to insulate S&Ls from market pressures. Those market pressures may be translated into savings and loan association failures unless S&Ls control their risk exposure.

During this transition the FSLIC is seeking alternative methods of managing its risk exposure as regulatory constraints are lifted. The problem is explored in this report from several angles, each representing an approach to restoring the market discipline effects that have been distorted by the present flat-rate deposit insurance system. Various approaches include risk-sensitive premiums that emulate market discipline, and privately supplied deposit insurance that injects private sector incentives into the system. This section considers the feasibility of altering the insurance coverage level to create uninsured creditors who will impose this desired market discipline on S&Ls, inducing them to operate in a sound and conservative manner.

The ability of the FSLIC to use insurance coverage to control risk-taking depends on the extent to which uninsured creditors are actually exposed to the risk of loss and how they react toward S&Ls. In addition, altering insurance coverage levels to enhance private market discipline is not a simple, straightforward procedure. Neither are the effects of increased market discipline straightforward.

A fundamental tradeoff is involved. Decreasing actual insurance coverage may increase market discipline, but the overall stability and viability of a given institution or the system may or may not be enhanced. Although increased market discipline in the long run will induce management to operate the association in a more financially conservative manner, the stability of the system may decline in the interim.

An example of this tradeoff is the insurance coverage on long-term large deposits. The issuance of long-term deposits would clearly reduce the mismatch between association assets and liabilities, reduce their interest rate risk exposure, and hence improve their financial stability. At present, attracting long-term funds to S&Ls is hampered by the $100,000 limit because the primary depositors of long-term funds are institutions rather than consumers. Should the FSLIC provide 100 percent insurance coverage for long-term deposits to allow S&Ls to tap effectively this source of large long-term deposits? Although it is clear that the short-term effects would be beneficial, it is equally clear that in the long-term, market discipline would be minimal.

An equally complex tradeoff occurs in the consideration of reduced insurance coverage in the consumer savings market. A decreased coverage level may induce consumers to be more careful in the selection of depository institutions and thus help to constrain risk-taking by those institutions. However, such a process is costly to society because of the time and effort that must be expended by consumers to evaluate institutional soundness. Furthermore, given the limited ability of consumers to evaluate accurately the financial stability of a complex financial institution, that added concern of consumers may result in a net destabilizing effect.

Market discipline can be exerted by uninsured depositors and by creditors and owners. Altering the level of insurance coverage can affect both stability and financial structure. The effectiveness of market discipline depends not only on the extent of coverage, but also on the methods used by the FSLIC to resolve S&L failures and on the quality of available financial information on S&Ls.

MARKET DISCIPLINE

In an unregulated financial system, the risks taken by financial institutions would be limited by their need to attract funds. Creditors would choose a depository institution on the basis of its soundness and conservatism. An institution that adopted a risky posture would find it very difficult to attract uninsured depositors. Deposit insurance changes the position, because insured depositors no longer have the same concern about the soundness of their institution. Free from this pressure from depositors, the insured institution may have an incentive to take the maximum risk allowed by the regulatory or insurance system; if the risk-taking insured institution is successful, the owners (stockholders) will reap the rewards. If the outcome is unfavorable, the loss will partly be borne by the insurance system.

The concept of market discipline rests on the twin suppositions that creditors choose a financial institution on the basis of its soundness, and that competition for business among financial institutions leads management to adopt conservative operating procedures and portfolios. The success of this approach has three requirements:

- There must be some uninsured creditors of depository institutions;
- These creditors must believe that their funds are at risk; and
- Creditors must be able to distinguish a sound institution from an unsafe one.

Uninsured Deposits

The use of market discipline to restrain risk-taking by insured S&Ls is affected by their liability structure. Almost all savings and loan deposits and other debt obligations are fully insured. As of December 31, 1982, more than 96 percent of all deposits in

FSLIC-insured institutions were fully insured. In addition, more than 92 percent of borrowed funds in insured institutions took the form of federal home loan bank advances, repurchase agreements, and mortgage-backed bonds that typically are fully secured by collateral. The remaining 8 percent of borrowed funds represent the maximum volume of uninsured deposits and debt obligations that are not collateralized; information is not available regarding the extent to which insured institutions collaterize the uninsured portion of deposits or debt obligations (such as bank loans, overdrafts on demand deposits, and commercial paper). It should be noted that the liability structure of insured S&Ls differs significantly from that of commercial banks with federal deposit insurance. Commercial banks have many deposit accounts that are not insured in full, with uninsured deposits accounting for about 38 percent of total bank deposits. Further, commercial banks have a sizable amount of nondeposit liabilities that are not insured.

The figures cited here do not prove that market discipline is ineffective for S&Ls. The inability of S&Ls to attract uninsured deposits may reflect the market's belief that all (or nearly all) S&Ls are in a weak condition, and that uninsured S&L deposits should be avoided. Market discipline may indeed be keeping the savings and loan industry from growing. However, uninsured deposits may be an important source of funds for some institutions; their ability to attract such funds may depend on the market's assessment of their condition and conservatism. As the condition of the industry improves, institutions considered sound by the market could possibly attract uninsured deposits.

An examination of available data casts doubt on this argument. Savings and loan associations have always attracted only small amounts of uninsured funds. They currently do hold a sizable number of $100,000 certificates of deposit, but they did not lure such funds when the insurance ceiling was at $40,000. Table II-1 compares the time deposits of $100,000 or more at S&Ls and commercial banks when various ceilings were in effect. Between 1973 and 1980 there was a strong incentive to hold uninsured deposits in S&Ls; during this period insurance coverage was limited to $40,000, while interest rate ceilings did not apply to deposits of $100,000 or more.

Nearly all individuals, even the very wealthy, can keep all their funds in insured accounts by splitting funds among several accounts--either at different institutions or in different legal capacities at the same institution. The principal reason commercial banks have more uninsured deposits than S&Ls is that they have attracted the accounts of large corporations, which find it impractical to maintain divided accounts. It is possible that if S&Ls attract corporate accounts, particularly checking accounts, they may end up with an increased volume of uninsured deposits. But this is unlikely; in fact, the limit of $100,000 on insurance coverage is more likely to restrict the ability of S&Ls to attract corporate

Table II-1. Time Deposits of $100,000 or More at Savings and Loan Associations and Commercial Banks

		$100,000+ Time Deposits (Billions)		Percent of Liabilities	
		S&Ls	Commercial Banks[a]	S&Ls	Commercial Banks[a]
$40,000 Coverage					
1976	December 31	$6.82	$109.9[b]	1.9%	--
1977	December 31	8.97	135.0[b]	2.1	--
1978	December 31	14.17	211.7	2.9	17.3%
1979	December 31	26.83	214.9	5.0	16.2
$100,000 Coverage[c]					
1980	June 30	$33.44	$212.7	6.1%	16.1%
	December 31	39.67	253.9	6.8	18.0
1981	June 30	43.12	230.7	7.2	20.8
	December 31	47.48	303.8	7.6	19.6
1982	June 30	51.27	333.9	8.1	21.0

[a] Data are for domestic deposits of insured commercial banks.

[b] From Federal Reserve Board. Release H6. Photocopy. Figures for 1976 are for January 1977.

[c] Deposit insurance coverage level increased to $100,000 on March 31, 1980.

Sources: Federal Home Loan Bank Board. Semi-Annual Reports. Photocopy, various issues; Federal Reserve Board. *Federal Reserve Bulletin*. Washington, D.C.: Government Printing Office, various issues.

customers. Moreover, the evidence from commercial bank experience with corporate customers indicates that, even for commercial banks, uninsured deposits are less significant than the data cited in Table II-1 indicate because of offsettable loans or collateralization of these deposits. This suggests that even if S&Ls successfully compete with commercial banks for corporate customers, their volume of deposits at risk is unlikely to be large.

The volume of uninsured deposits might be increased by decreasing insurance coverage. Consideration of the data on uninsured deposits with lower levels of insurance coverage suggests that moderate reductions in coverage will not significantly increase the volume of uninsured deposits. Even with a 50 percent cut in insurance levels, depositors could maintain the same level of insured deposits in S&Ls without much difficulty, by splitting accounts or by using the services of brokers (who could package the insured certificates of deposit of a number of institutions into whatever size was demanded by the market). Currently, brokered deposits account for less than 1 percent of S&L deposits, but the importance of these accounts may increase if such arrangements become necessary to achieve full deposit insurance coverage. However, the most likely effect of a significant reduction in insurance coverage would be a reduction in the deposit volume of S&Ls. Commercial banks are now widely perceived as less likely to fail than savings institutions. Depositors concerned with safety are more likely to move their accounts to commercial banks than to seek out another S&L that they believe is safer; this would be true even if commercial bank insurance coverage were reduced pari passu with that of the S&Ls.

A reasonable conclusion is that market pressure from uninsured creditors is not now a significant conservative force for S&Ls because such accounts are only a small percentage of S&L deposit volume. An attempt to increase the volume of uninsured deposits by reducing insurance coverage is unlikely to be successful. Such a reduction is more likely to result in a declining role of S&Ls in the economy.

Risk Sensitivity of Uninsured Depositors

Successful use of market discipline as a force for conservatism requires not only the existence of creditors at risk, but also a belief by the uninsured creditors that they are at risk. Most failures of FSLIC-insured institutions have been handled by arranging mergers that protect all creditors of the failed institution. This method of handling failure is preferred because it is least disruptive to the community and, usually, the cheapest to the FSLIC. This approach does mean that uninsured deposits are not really at risk; accordingly, there is no reason for uninsured depositors to believe that their funds are at risk.

The FSLIC has had some experience with failing institutions, however. Seven payouts occurred up to 1941; one in 1965; two in

1966 and 1968; one in 1971, 1981, and 1982; and two to date in 1983. Of these 17 cases, losses to uninsured depositors occurred only in the last three.

Depositors who are actually at risk may not be aware of that risk and therefore may not act accordingly. With few exceptions, failures do not occur suddenly; well in advance of the actual closing of the institution, reports by the press indicate trouble of some sort. Cautious uninsured depositors need not feel at risk until they hear that the institution is having problems. Then, if the deposit is a demand deposit or a time deposit with short maturity, there is ample opportunity to withdraw funds.

The FSLIC's experience with the receivership of Fidelity Savings and Loan Association of Oakland, California, offers an example of this behavior, On April 13, 1982, following months of discussion of the institution's problems in the press, Fidelity was put into federal receivership. From that date until the final approval of the acquisition of Fidelity by Citicorp of New York on September 28, 1982, deposits flowed out at an average rate of $1 million per day. The five "phoenix plan" institutions established by the FSLIC are generally known to be receiving government assistance, yet deposit outflows have been more modest than experienced by Fidelity. This suggests either that depositors do not follow the news concerning their financial institutions and do not make judgments based on such information, or that depositors are rather sophisticated and believe that their funds will be protected by a merger transaction in the event of failure.

Another reason why depositors at risk may not behave accordingly is that the distribution of depositors who have suffered losses in failures has been arbitrary; that is, the losses may not be caused by a lack of diligence in the depositor's choice of institution. No depositor has suffered a loss in the failure of a large institution; such failures have been handled through merger transactions. To avoid loss, depositors have not had to choose between safe and unsafe institutions, but only to choose a large one. Thus, large institutions have not had to compete for deposits on the basis of conservative management.

Furthermore, loss is more likely to occur when the supervisory process has overlooked the reason for or size of the loss. As described by the Federal Deposit Insurance Corporation (FDIC) director of research in discussing the commercial bank experience (Silverberg 1980, 210):

> If an institution is closed when it becomes insolvent, and bank supervisors are on top of the situation, the loss should be a small percentage of total liabilities. For the relative loss to be substantial, it probably needs to be hidden or missed in the supervisory process. Of course, it is unrealistic to expect depositors to anticipate activities missed by examiners and, in that sense, there is a unfairness about which depositors lose in bank failures.

If market forces are to have a significant effect in restraining risk-taking by insured institutions, that discipline must come from uninsured depositors; but experience does not support the notion that such discipline would be forthcoming. In addition, if market discipline is to be a constructive force, it must operate at all times, not only when an institution is known to be in trouble. Once the risky institution has a well-publicized setback (such as default of large borrowers or adverse interest rate movements), an outflow of deposits can no longer temper the risk-taking proclivities of the institution. Depositor outflows after problems are recognized and published do not reduce risk; in fact, such moves exacerbate the difficulty of resolving the institution's problems.

Although the evidence does not support the view that market pressure is important in restraining risk-taking by insured institutions, there are a few possible qualifications to this conclusion. First, the behavior of depositors with demand deposits and those with time deposits may differ. The demand depositor may be willing to place a large deposit in an institution without careful evaluation because of the expectation that in case of trouble, funds can be withdrawn quickly without loss. The depositor who intends to commit funds for three or four years, or even for six months, may be more cautious, particularly if substantial penalties are attached to early withdrawals. If time deposits are to play an important part of the liability structure of S&Ls,

market pressure may become significant. The relative absence of uninsured long-term deposits in S&Ls at the present time may reflect a market judgment of risk; more likely, it reflects the greater attractiveness of other instruments to large investors during the past few years. This could change as deposit rate ceilings are removed.

Second, in response to a survey by the Federal Deposit Insurance Corporation (FDIC), corporate treasurers indicated that they screened potential bank connections to determine the dependability of credit lines. It would seem that the considerations involved--liquidity and capital adequacy--would be similar to the criteria involved in a safety analysis. Thus, corporate treasurers' screening process may be the type of market pressure now being sought.

Third, uninsured depositors seem to avoid S&Ls in general, although they apparently do not discriminate among S&Ls. This may indicate a potential development of market discipline, especially if better information is made available.

Fourth, depositor attitudes have been shaped by the practice of handling failures through mergers. Although this approach is clearly the most appropriate means of dealing with nearly all failures, the use of payouts for a few failures could possibly change the perceptions of depositors. Such an increase in uncertainty may have a beneficial effect on market discipline and justify an occasional departure from the merger approach. It may be necessary for the federal insurance agencies to make a formal policy declaration to put uninsured depositors on notice that they are at risk if their institution should fail.

Assessing Risk in Savings and Loan Associations

Market pressure to encourage conservative management can be effective only if depositors are able to distinguish between safe and risky institutions. It is by no means clear that this ability exists. The setting of risk-related premiums demonstrates the difficulty of measuring risk--a difficulty much greater for individual depositors than for the insurance agency.

A substantial body of literature documents attempts to determine from publicly available data the risk of failure of banks and other firms. These include analyses of failed banks and those on the "problem lists" of the supervisory agencies. The attempt to predict problem status or possible failure from public data is based on the assumption that market participants would have access only to such data (as compared with examination data available to the supervisory agencies, for example). However, large depositors may be able to obtain nonpublic data directly from institutions in which they are considering a large deposit. Several studies have produced results that are statistically significant--that is, their attempts to identify banks likely to become problem institutions have been more accurate than is likely to be accounted for by chance. But such predictions are not necessarily accurate enough to act as the basis for depositors' decisions.

If insurance coverage were limited, resulting in more uninsured depositors, and if those depositors believed that they could lose funds in a failure, incentives to develop better techniques for distinguishing between safe and unsafe institutions would be created. There are several reasons to doubt that this will occur, however.

Depositors faced with the risk of loss through failure may simply decide to make only insured deposits or to deposit only in institutions that they believe the regulatory officials would not allow to fail. S&Ls attract few sophisticated depositors with large sums who would have reason to make the necessary risk assessment; the incentives for such investors are insufficient. Why should Salomon Brothers learn to distinguish safe from unsafe S&Ls when it can put its money market funds in more familiar and traditional instruments? Of course, in a free market there will be some price at which S&Ls can attract uninsured depositors, and some large depositors or institutional investors would move funds to S&Ls for a sufficiently high-yield premium. But this is impractical. If large S&Ls are faced with a substantial interest cost disadvantage vis-a-vis commercial banks or institutions that can obtain large amounts of insured deposits, they will not be able to survive in a competitive financial system. If large yield differences exist between insured and uninsured funds, it is more likely that insured deposits would be packaged into institutional sizes than that funds would be moved to uninsured deposits. A large yield difference provides brokers and others with the opportunity to make this move profitable.

This negative view of the likelihood of depositors' distinguishing the soundness of individual S&Ls requires one qualification: most of the existing experience and statistical work has been limited to commercial banks. The riskiness of S&Ls may be easier to assess than that of commercial banks; the major source of risk to S&Ls is interest rate risk, and that type may be easier to measure than credit risk or risk in the other activities of commercial banks. As S&Ls broaden their lending activities to include commercial and consumer lending, a measurement of their riskiness may become more difficult.

Other Implications of Altering Insurance Coverage

Although the efficiency of the regulatory and insurance system would be improved if more market discipline were introduced by altering the level of insurance coverage, an increased reliance on market pressure is probably not feasible in the thrift industry. Even if it were feasible, additional effects must be considered--effects on the deposit insurance system that most would regard as undesirable. Several of these have been suggested already and need only to be summarized here; others receive more detailed discussion later in this report.

One direct effect of any increase in market discipline is an increase in the risk of loss to the public in case of financial institution failure. A well-designed system would seek to ensure that the bulk of this loss would be felt by large, presumably knowledgeable, depositors and investors. In any such system, however, some unsophisticated depositors may well suffer losses. Their number will increase as the level of deposit insurance coverage falls.

Greater reliance on market pressures, and more uninsured depositors, means increased chances of a liquidity crisis when an institution is known or suspected to be in trouble. The costs and gains to depositors in such crises are asymmetric. Confronted with a rumor about a bank or thrift institution that may or may not be true, depositors have every incentive to move their funds as quickly as possible. If the rumor is false, the cost of unnecessarily moving funds is small (particularly for demand deposits). If the rumor is true, the rewards of doing so are great. Unfortunately, if many depositors act in this way, the rumor becomes self-fulfilling. Federal deposit insurance was initially established to remove the incentive for such behavior. Furthermore, even if the rumors are true, and the institution really is weak, such hasty withdrawals are counterproductive because they reduce the time in which the insurance agency could work out a merger or assistance plan to reduce the losses from failure.

Another effect of increased market discipline through reduced deposit insurance coverage may be a smaller share of the financial services market for S&Ls. Even if S&Ls were viewed as equally sound as commercial banks, the public may still regard large commercial banks as less likely to fail. For some time to come, S&Ls are unlikely to be viewed as being as strong as commercial banks.

MEANS OF ACHIEVING MARKET DISCIPLINE

This discussion has assumed that increased market discipline requires reduced insurance coverage or an increased sense of risk by uninsured depositors. The direct approach to achieving this is a reduction in the insurance coverage level, perhaps coupled with (or replaced by) greater use of the deposit payout instead of the arranged merger in case of failure. But some alternatives, or at least variations, deserve consideration.

The simplest approach is to make no change in deposit insurance coverage; over time, inflation and increases in wealth will enlarge the average size of deposits and thus the number of uninsured depositors. Increased market discipline will come about gradually, rather than as a sudden result of a cut in insurance coverage, which may be disruptive to the industry and to depositors.

Another variation is to return to the partial coverage scheme of the original federal deposit insurance legislation. The Home Owners' Loan Act, signed by President Franklin D. Roosevelt on June 13, 1933, called for full insurance coverage for each depositor of the first $10,000 of a deposit, 75 percent coverage of the amount between $10,000 and $50,000, and 50 percent coverage of the amount over $50,000. This insurance program was scheduled to go into effect on July 1, 1934; but a temporary plan adopted by Congress for the interim period was extended, and the original scheme never took effect. Nevertheless, this plan has some advantages over the current system. It would greatly increase the number of depositors who would be at risk; however, it would provide greater insurance protection for very large deposits (a $200,000 deposit would have $140,000 of insurance, whereas only $100,000 is currently insured), and thus might increase the ability of S&Ls to attract larger deposits.

Requiring S&Ls to obtain some amount of uninsured liabilities--in the form of large deposits or other (unsecured) liabilities--would increase the role of uninsured creditors. An S&L unable to attract the necessary volume of such funds would be subject to action (including closing or merger) by the FSLIC. An S&L perceived by the market as operating in a risky manner would presumably have to pay a higher than normal interest rate to attract such funds.

Alternatively, such an uninsured liabilities requirement could take the form of subordinated debt. Holders of subordinated debt have an interest in conservative operation because, after the equity holders, they are most exposed to loss. Unlike stockholders, moreover, these investors do not share in any profits that result from incurring additional risk. Subordinated debt provides a cushion for the FSLIC in dealing with failed S&Ls, and loss can be imposed on holders of such instruments even when a merger is arranged to resolve a failure. In terms of increasing market discipline, subordinated debt may be more effective than equity because holders of subordinated debt have no incentive to increased risk-taking.

It may also be useful to note the differences in behavior of uninsured holders of demand deposits and time deposits. Holders of demand deposits correctly assume that their funds can almost always be moved at the first sign of trouble, thus avoiding loss. Moreover, their tendency to do so speeds up the forced closing of the institution and makes arranging a merger more difficult. Holders of time deposits have more incentive to choose an institution on the basis of its soundness, because they may not be able to withdraw funds without loss if trouble arises. This suggests a system in which demand deposits are insured in full and insurance coverage on time deposits is limited. This approach holds most merit if demand deposits pay no interest (or very low interest), and if there are no very short-term time deposits paying market rates. It becomes less attractive when S&Ls can offer market rates on a very short-term time deposit--the money market deposit account, for example. The depositor may simply choose a short-term time deposit that can be withdrawn without penalty or loss if indications of trouble arise. This scheme also makes short-maturity liabilities attractive, which may conflict with the asset-liability management needs of thrift institutions.

Making uninsured depositors feel at risk does not require adopting the payout approach in failures. It might, for example, be possible to arrange a system in which insured depositors would be protected immediately and fully in a merger, while uninsured depositors suffered some loss or some delay (Golembe 1977).

A method can be developed to ensure that uninsured creditors share some of the insurance agency's loss when a merger is arranged to resolve a failure. Such a system would have several advantages: the insurance agency could nearly always use the merger approach, even when uninsured creditors existed; there would be no conflict with the desire to minimize costs; and market discipline could play a role because uninsured creditors would be at risk. Such a legislated change in the priority of claims would have some undesirable aspects: financial institutions might find it harder to obtain nondeposit liabilities, and it might be necessary to protect certain uninsured creditors, such as employees. However, if market discipline is to be seriously pursued as a means of controlling risk, this approach may be appropriate.

One way might be to arrange a merger whereby the acquiring institution assumes all of the insured deposits and a fraction of the uninsured deposits, depending on the FSLIC's estimate of the ultimate losses on the assets of the failed S&L. As assets are liquidated, the FSLIC and the uninsured creditors would share equally in the loss. Another alternative would be a change in liquidation priorities so that depositors (or even insured depositors) were given a claim senior to that of other creditors. Clearly, such a change in legal preferences would require new legislation (although the former approach is within the existing authority of the FSLIC).

Despite these generally negative conclusions about the probability of increased market discipline through increased uninsured deposits, it should not be assumed that market discipline is completely lacking in the savings and loan business. Market discipline does operate in the equity market. Investors in savings and loan stocks are concerned with the safety of their institution; they are not protected in case of failure, and they will buy securities from those S&Ls that operate in accordance with their risk preferences. It is not known for sure, however, whether their preferences are for conservative or risky operations. With respect to commercial bank stocks, it has frequently been asserted that the market prefers banks with less risk. Bank stocks with less interest rate risk exposure sell at higher price-earnings ratios than stocks of banks with greater interest risk exposure (Beighly, Boyd, and Jacobs 1975). Unfortunately, the data are insufficient to prove that this assertion is correct.

Mutual vs. Stock Organization

The predominance of the mutual form of organization in the S&L industry has implications for the impact of market discipline on the behavior of institutions. Generally the incentives in managerial decisionmaking are somewhat different for mutual associations than for stock associations. This difference is neither sharply defined nor substantial; it is subtle and for the most part a matter of degree. Because of these incentive differences, many studies have concluded that stock associations are more aggressively managed than are mutual associations. Many exceptions to this rule occur, of course; on the average, however, stock associations do tend to behave somewhat differently than do mutual associations.

To discern the differences between stock and mutual associations, consider the variety of market disciplines imposed on a business firm. For purposes of this discussion, three disciplines are noteworthy. First, investors who hold debt instruments issued by the firm are wary of risk-taking by the firm. Excessive risk-taking may cause bankruptcy and a partial loss of these creditors' investment. If a firm is perceived to be taking increasing levels of risk, investors react by demanding higher interest yields on the debt instruments of that firm. Second, investors who hold stock in a business firm have motivations and reactions similar to debtholders'. However, shareholder losses are greater in bankruptcy; thus, their reaction to risk-taking is more acute. Third, the managers of the firm discipline themselves against excessive risk-taking because of their vested interest in preserving their own jobs and the value of any stock options that they may own.

These three incentives are affected by the particular circumstances of S&Ls. The first element--risk-related debt cost--is largely absent because of deposit insurance. The second element--the discipline of "owners"--is more diffused in a mutual association. The third element--managerial self-discipline--is present in both mutual and stock associations, but the discipline may be more well defined in stock associations because of equity ownership by management.

Considering the second element in more detail, the discipline of the "owners" of an S&L is more diffused and weaker for mutual associations. First, the number of owners is much greater and hence the power of ownership is diluted. The number of "depositor owners" of a mutual is likely to be much larger than the number of "common stock owners" in a stock association. Second, the incentive for active participation by the owners is reduced in mutual associations. Depositor owners do not receive additional dividends if the association is aggressively, efficiently, and effectively managed. Thus, they have less incentive for encouraging the most effective management for the association.

Regarding the third incentive element, managers of both stock and mutual associations are interested in preserving their jobs and both may be induced by performance bonuses to manage the firm effectively. However, the rewards for stock association managers may be supplemented by stock options and stock ownerships. These features provide greater monetary incentives in both the short-term performance and the long-term viability of the association. For the most part, mutual association managers cannot receive an ownership share, which would produce an additional incentive for enhancing the long-term viability of the association.

Thus, stock associations provide a wider array of incentives for effective management and the avoidance of excessive risk. These differences are not substantial; but they are significant enough to cause an empirical difference in the operating behavior of associations. Thus, one means of instilling more market discipline to control risk-taking is to encourage the conversion of mutual associations to the stock form to create those broader incentives.

EFFECTS OF ALTERED DEPOSIT INSURANCE COVERAGE

The U.S. federal deposit insurance system has always been based on partial coverage of deposits, rather than insurance of all deposits. The level of coverage has been increased since the system was established, reflecting inflation and increased holdings of financial assets. The relationship between the extent of deposit insurance coverage and the influence of market factors on the risk levels of insured institutions is important. The level of deposit insurance coverage has a number of other effects that must be taken into account when considering changes in the level of deposit insurance coverage.

Macroeconomic Effects

If there were no deposit insurance, the financial system would be subject to liquidity crises as depositors withdrew funds from institutions that they feared were in danger of failure. Such crises not only affect individual institutions and depositors, but also have macroeconomic effects. A dramatic withdrawal of funds, even if the institution is able to weather the outflow, results in a decline in the money supply. A loss of confidence in depository institutions, which produces an increase in the public's demand for currency, reduces the reserves available to the financial system. In principle, such a change in the currency ratio could be offset by the Federal Reserve; however, maintaining stability of the money supply is clearly more difficult when commercial banks and thrift institutions are subject to sudden large outflows of funds.

Indeed, protection of the money supply was the primary reason for creation of the FDIC in 1933. In discussing the motives behind federal deposit insurance, Golembe (1976, 6) states that "...the most important was protection of the circulating medium. Next in importance was the desire to preserve the existing, unit banking structure. Safeguarding small depositors against loss was further down on the list." Friedman and Schwartz (1963, 434) argue that "Federal insurance of bank deposits was the...structural change most conducive to monetary stability since state bank notes were taxed out of existence...." Evidence for this view is found in the original plan for deposit insurance, which would have covered 50 percent of deposits greater than $50,000--a magnitude inconsistent with concern for protecting small depositors.

Stability of the money supply is directly related to deposit insurance coverage; that is, monetary stability is improved by increased deposit insurance coverage up to 100 percent insurance. The deposit outflows prior to the collapse of Franklin National Bank in New York required Federal Reserve discount window lending to Franklin of more than $1 billion--an amount large enough to affect the aggregate level of the money supply. With 100 percent deposit insurance, Franklin might not have been subject to these deposit outflows in the first place.

Such considerations do not demonstrate that 100 percent deposit insurance is necessary or desirable; other effects of changes in the level of insurance coverage must be considered. However, increased deposit insurance coverage does add further stability to the money supply; a decrease in coverage would have the opposite effect.

Effects on Depositors

Changes in the level of deposit insurance coverage are unlikely to have a major effect on the protection of individual depositors. Nearly all individual depositors, in both commercial banks and S&Ls, are now protected in full. An increase in insurance coverage limits therefore would not affect depositor protection significantly, although it may have some effect on the convenience of those few depositors who must now split their funds among several institutions to obtain their desired amount of insured deposits.

A moderate reduction in deposit insurance coverage is also unlikely to have significant effects on depositor protection. If coverage were cut to $50,000, for example, many holders of $100,000 accounts would redistribute their funds to maintain 100 percent coverage (at some sacrifice of convenience). A cut of this size or larger would stimulate the packaging of insured certificates of deposit by brokerage firms for resale in larger denominations.

The most significant factor affecting the extent of insured deposits in the portfolios of individuals has been legal interest rate ceilings on deposits. Rate ceilings led to the development of money market mutual funds and stimulated the flow of deposits from accounts at commercial banks and thrift institutions into money market funds. Although a large part of the outflow returned to the banking system through certificate-of-deposit purchases by the money market funds, the net effect was a replacement of insured deposits with uninsured deposits and other financial assets. The recent actions of the Depository Institutions Deregulation Committee establishing the money market deposit account (MMDA) should result in an increased role of insured deposits in the portfolios of individuals. The MMDA already amounts to more than 20 percent of deposit balances at S&Ls. These new accounts are likely to be more significant in this regard than any feasible change in the extent of deposit insurance coverage.

Effects on Financial Structure

Deposit insurance is an important factor in the ability of S&Ls to attract funds. Because commercial banks are viewed as safer than S&Ls, the latter have few uninsured deposits. This view is important when competing for large deposits that cannot conveniently be divided among institutions or accounts (such as the funds of corporations, financial institutions, and brokers). At the current levels of deposit insurance coverage, S&Ls can compete on an equal basis for deposits of up to $100,000, but face a disadvantage in competing with commercial banks for very large accounts. With deposit insurance up to, for example, $1 million, or with 100 percent deposit insurance, the competitive position of S&Ls would be improved; a cut in coverage would make their position worse.

This analysis is consistent with the view that changes in the extent of coverage will not significantly affect the extent to which depositors are protected. That is, depositors will manage their portfolios to receive close to 100 percent insurance coverage for their deposits in S&Ls. Changes in the level of deposit insurance protection will primarily affect the size of the savings and loan industry.

Altering the insurance coverage level will affect not only the competitive structure of S&Ls with respect to commercial banks, but also the place of other financial instruments in the financial system. Disintermediation, which began in the mid-1960s in response to interest rate ceilings on deposits in financial intermediaries, led to investments in financial instruments that may involve a less desirable combination of risk and return than would be attainable with insured deposits free from rate ceilings. The amount of commercial paper, repurchase agreements, government securities, and other financial instruments held by the public may change significantly if deposit insurance coverage is changed.

Altered insurance coverage will also affect the competition between small and large institutions. In the absence of government regulation or deposit insurance, there may be reasons to expect large institutions to be safer than small: better opportunities for diversification, greater access to liquidity, and ability to afford better management, among others. Regardless of the relative safety of large and small institutions, there is good reason to believe that an uninsured deposit in a large institution is safer than an uninsured deposit in a small one under the existing system of partial deposit insurance. That view rests primarily on the procedures followed in case of failure, not on an assessment of the risks of failure. All failures of large institutions have been handled by arrangements that have protected all depositors (although Penn Square National Bank may be viewed as an exception). An increase in deposit insurance coverage would clearly increase the relative ability of smaller institutions to compete for larger deposits. Over time, the effect of such change would be toward reducing concentration ratios in financial markets. Conversely, a decrease in insurance coverage would have a greater effect on small institutions than on large, decreasing their market share.

For many years bankers and economists have predicted that fewer independent depository institutions would make up the U.S. financial system. The removal of deposit interest rate ceilings will stimulate such consolidation, as will any movement toward interstate branching or holding company acquisitions. A change in the level of deposit insurance coverage would have a potentially greater effect on such a development; this deserves consideration in weighing the costs and benefits of any change in such coverage.

Effect on the Cost and Risk of the Insurance System

The effect of altered insurance coverage on the cost of operating the deposit insurance system is difficult to assess. Despite the fact that the federal deposit insurance system has always used limited coverage, failures or threatened failures of insured institutions have usually been handled to protect depositors in full. This has been true not only of S&L failures, which have relatively small volumes of uninsured deposits, but also of commercial bank failures. In retrospect, it appears that the insurance system losses would be the same whether insurance coverage were at 100 percent or at a lower level. As long as the insurance agencies handle failures through arranged mergers, the legal extent of coverage is irrelevant in determining the extent of insurance fund losses.

The view that the extent of insurance coverage is irrelevant to the cost or risk of the insurance system neglects two important considerations. First, the level of insurance coverage affects the risk undertaken by insured institutions. With 100 percent deposit insurance, a tendency to increase risks would occur (unless prevented by regulation or insurance premiums that vary with risk). If insured institutions become riskier, losses to the insurance system may increase. Second, the level of insurance affects the choice of methods used to deal with failures. The insurance agencies believe that they have an obligation to minimize costs; cost-minimization suggests the choice of different methods according to the level of insurance coverage.

When an insured S&L fails or is in danger of failure, the FSLIC can pay out to insured depositors, arrange a merger, or provide direct assistance to keep the ailing S&L in operation. It is usually cheaper to arrange a merger than to liquidate the failed institution. The cost-minimization calculation changes, however, when large amounts of uninsured deposits are involved. In a payout, the uninsured depositors share the loss with the insurance fund--the more uninsured deposits, the greater the sharing. If a reduction in insurance coverage resulted in increased uninsured deposits, the cost-minimization obligation would suggest an increased use of deposit payout. With large uninsured deposits, a merger can be arranged only at a significant additional cost; although this has frequently been done in the past, it may be more difficult in the future. The elimination of interest rate ceilings will reduce the volume of below-market-rate deposits available to an acquiring institution, making them less willing to pay substantial premiums.

As described earlier, depositors at risk in a failure have an incentive to withdraw their funds at the first sign of danger. This action makes it difficult to arrange mergers, because such arrangements take time. This effect could reinforce the tendency toward more frequent use of the payout method, conflicting with the general presumption that the widest possible use of the merger approach is in the public interest. This consequence of change in the level of deposit insurance coverage may well be the most important, and the public policy conflict that this implies should be considered explicitly. A high level of deposit insurance facilitates the use of mergers to resolve failures and provides maximum protection to depositors with minimum disruption to the community and the financial system; a low level of deposit insurance coverage provides an opportunity for market discipline to restrain risk-taking, allowing for reduced government regulation and, perhaps, reduced risk to the insurance system.

Other Effects

The level of deposit insurance coverage also affects the timing for closing a troubled institution. When many uninsured deposits are involved, the loss to the insurance system is a function of the time at which an insolvent institution is closed. Because uninsured depositors can be expected to withdraw funds over time, their availability to share losses with the insurance funds depends on how promptly the institution is closed. If all deposits are insured, however, deposit outflows will not be crucial (at least they will not result in greater losses to the insurance fund), and the timing of the closing of an institution becomes arbitrary. It would be feasible for an insolvent institution to be kept operating indefinitely, as was the case with many thrift institutions in 1982. Competing institutions view this approach as inequitable because they are subjected to competition from institutions that are operating only because of government interference in the market.

In most jurisdictions, banks and thrift institutions that seek deposits from public bodies must pledge securities as collateral for these public funds. This protection for state and local governments would be unnecessary under a system of 100 percent deposit insurance. Because pledging requirements interfere with efficient asset allocation, the opportunity to eliminate such requirements is one of the benefits of increased deposit insurance.

FINANCIAL DISCLOSURE AND DEPOSIT INSURANCE

The effectiveness of market discipline is affected by the availability of information on institutions' operations. The costs and benefits of increased disclosure differ depending on the importance of uninsured deposits.

Depository institutions have historically been treated differently from other corporations with respect to requirements for disclosure of financial information. One of the first forms of financial regulation, enacted in several states, was a requirement that banks periodically publish a "report of condition," or balance sheet. This disclosure was intended as a form of market discipline; depositors or noteholders of each bank would be provided with data necessary to make informed judgments about the soundness of the institution.

As regulation and supervision of banks developed in the United States, disclosure became less important. As noted, the liabilities of banks and thrift institutions have very short maturities, so that disclosure of unfavorable information can lead to rapid withdrawal of funds. Further, unless large penalties for early withdrawal are attached to time deposits, depositors suffer few costs to move their funds from an institution making such disclosure--moving either into another institution or converting funds to currency--while potential losses from ignoring unfavorable information are great. This asymmetry leads to a potential for instability that makes the task of the supervisory agencies more difficult. Traditionally, supervisory officials have assumed that problems can be handled more easily in the absence of publicity. Undoubtedly, secrecy has enabled supervisors to work out a number of problems to avoid loss to the public--problems that would have resulted in failure had depositors been aware of them.

Justifying nondisclosure of risk is easy if the level of risk is negligible and if disclosure in itself would increase that risk. Even when the efforts of supervisors are unsuccessful, the losses are not necessarily any greater than if disclosure had been prompt (although the distribution of losses may be quite different).

It is difficult to determine whether the public has been well served by the supervisory penchant for secrecy. The record of failures before deposit insurance does not justify the claim that risks were so low that disclosure was unnecessary. It would, however, be unrealistic to assume that with greater disclosure all market reactions would be correct, with depositors withdrawing funds only from institutions that would inevitably fail and leaving funds in institutions that could be saved. The real question is whether, in the long run, market discipline fortified with good information can be more effective in reducing failures than are the FHLBB supervisors' efforts to handle problems in secrecy. Market discipline can work only on the aggregate level of risk over time. In the individual case, disclosure can only make the problem worse, not improve it; once adverse information is disclosed, it is too late for market discipline to serve as a restraining force.

The supervisors' preference for secrecy was bolstered by the introduction of deposit insurance. From the point of view of insured depositors, disclosure is irrelevant. The choice among institutions is not influenced by financial information, because the depositors rely on deposit insurance for protection; more importantly, in case of failure depositors are not harmed by lack of information. Uninsured depositors may have an interest in financial information, but as long as failures are handled so as to protect all depositors, they have no need for information. The recent interest in increased financial disclosure by banks comes on the heels of the Penn Square failure, which did result in loss to uninsured depositors. Many of these depositors argue that they would have avoided loss if they had been appropriately informed about the activities of the bank. These considerations suggest that it is necessary to analyze separately the effect of increased disclosure on insured depositors, other creditors, and equity holders.

Disclosure and Insured Depositors

Additional disclosure is not necessary to or helpful in the protection of insured depositors, but the converse of that conclusion is also important: if all depositors are insured, disclosure will not be a destablizing force. The principal reason for restricting disclosure is concern that release of adverse information will lead to a liquidity crisis, which will make more difficult or preclude actions that might save the troubled institution. If all depositors are insured, such a crisis will not develop. Evidence on deposit flows of institutions with publicized problems provides strong support for this conclusion. Although this does not offer positive guidance as to the most appropriate disclosure requirements, it does indicate that banks or financial institutions should not be treated differently from other businesses.

Disclosure and Uninsured Creditors

Disclosure has several effects on uninsured creditors. If the insurance agencies protect the position of uninsured creditors by arranging mergers of failing institutions, disclosure is not helpful to uninsured creditors. In these circumstances, disclosure may even be harmful. If there is uncertainty about the determination of the insurance agency to arrange a merger, negative news may lead uninsured depositors to withdraw their funds. This outflow of deposits may make it more difficult to keep the institution open and may not allow sufficient time to work out a merger. Hence, uninsured creditors may fare better if adverse information is not revealed.

This analysis ignores the potential benefits of increased market discipline. As discussed earlier, market discipline can only be effective if some creditors, believing that their funds are at risk, choose among institutions to minimize risk. Creditors are unable to make such choices in the absence of information. The question then turns on whether market discipline can be a constructive force when information is available.

There is reason to believe that accurate disclosure of the risk undertaken by a financial institution will tend to discourage risk-taking. Assume that a financial institution is controlled by a group that prefers a riskier posture than the majority of competing institutions. A riskier portfolio should lead to proportionately higher expected returns. If the group must finance that portfolio with uninsured deposits, they must offer the uninsured depositor an expected return that is more than proportional to the increased risk. (If the portfolio can be financed solely with insured deposits and if insurance premiums are not based on risk, the institution can earn a higher-than-normal expected return with the insurance system bearing the higher-than-normal risk.) The return promised to the uninsured depositors would absorb the returns expected from the riskier-than-normal portfolio; no excess returns would be expected from operation of this riskier-than-normal institution. This is the reason for believing that market discipline can lead to reduced risk-taking by financial institutions. Because disclosure is essential for this effect, it is reasonable to regard increased disclosure as promoting stability in the overall financial system (or stability "in the large").

Disclosure has a different effect in individual cases. Once a risk has resulted in a worse-than-expected outcome, disclosure of that outcome can have a destabilizing effect as uninsured depositors withdraw funds. In this sense, disclosure can be destabilizing "in the small." For example, if banks that need to attract uninsured depositors are required to disclose the volume of their loans to borrowers viewed as riskier than normal, they will tend to reduce the volume of such lending. The effect of the disclosure requirement and market discipline is to reduce risk. Of course, some such loans will be made, presumably at rates that justify the risk. If those borrowers do experience difficulty, the required public disclosure of such loans may create liquidity pressure on the bank.

Although disclosure can contribute to market discipline in conjunction with uninsured creditors at risk, it does not have this effect if no creditors believe themselves to be at risk. If uninsured creditors believe that they will be protected in case of failure, market discipline cannot be effective, and disclosure does not contribute toward it. The effect of minimal disclosure may be to shift uninsured deposits to large institutions and to commercial banks, which are viewed as safer; more disclosure may lessen this tendency.

Disclosure and Stockholders

Disclosure is most important to the stockholders of financial institutions. Stockholders choose among alternative investments based on their assessments of expected returns and risks. Research on stock prices indicates that the market is an efficient processor of information, in that relative stock prices appropriately reflect available information. Nevertheless, empirical research also suggests that there are excess returns to inside information; that is, the market does not reflect information not available to it.

From the point of view of effective market discipline, it is important that market prices reflect the true risk-return position of the institution. The typical investor (and the market as a whole) is believed to be averse to risk; that is, the market will demand a higher-than-normal expected return from an investment believed to be riskier than average. This tendency would press those in control to adopt a conservative operating philosophy, but such pressure would succeed only if there is a general belief that the market reflects the true position of the institution. Confidence in such a belief occurs only if there is adequate disclosure of information.

Some stockholders may prefer an institution that offers high risks and high returns to one that selects lower risks and lower returns. Disclosure may make that choice easier. If the alternatives were full disclosure or no disclosure, it is not certain that full disclosure would lead to lower risk. The position now is one of partial disclosure of risk information but full disclosure of return-to-shareholders information. If improved risk information were supplied, it would probably reduce the stock price of riskier firms, providing an incentive for conservative operating policies.

Disclosure of adverse information to equity holders does not create destabilizing effects for the institution itself. Stockholders may sell their stock, or the stock price may fall, but this does not affect the finances of the S&L. The implication is that depository institutions should be subject to the disclosure rules applied to corporations generally if there are no uninsured depositors. It can be argued that financial institutions should be subject to stricter requirements for disclosure because such disclosure may provide a public benefit in reducing incentives toward excessive risk-taking. Disclosure requirements for other corporations are aimed primarily at stockholder protection rather than at promotion of a social objective.

Once again, disclosure (and market discipline generally) can benefit S&L operations only if it is part of a continuing process. Disclosure of serious problems after they occur may protect some investors, but it does not serve the purpose of reducing risk-taking. To accomplish that, disclosure must regularly include the information that the market needs to assess the level of risk.

Information to Be Disclosed

General principles to guide the development of specific disclosure requirements for S&Ls can be set forth. These principles may conflict, however, with other objectives of thrift institution supervision.

Whatever information would be necessary to set risk-related deposit insurance premiums is, by definition, useful for measuring risk and therefore should be disclosed. Beyond premium assessment, whatever information the supervisory agency finds necessary to perform its functions is equally relevant to market participants and should also be disclosed.

Application of these principles need not raise concern over the cost of developing information. If the information is required by the supervisory agency for its needs or in connection with the insurance premium system, the additional costs to disclose this already-gathered information would be modest. Of course, the agency must consider the costs to the S&L of generating additional information. Further, if information is needed to evaluate risk, management should have collected that information even without an agency requirement. The additional costs involved in disclosure are similarly modest.

Some issues are fairly simple to settle in this context; others are controversial. For example, although information on the volume of past due and nonperforming loans obviously should be disclosed, it is less clear whether data on loans classified by examiners should be made public. The former data are objective, while the latter rely on examiners' judgments. If aggregate data on classified loans were disclosed, there would be no need for disclosure of the classification status of individual loans.

A more difficult issue concerns the disclosure of supervisory agency criticisms of the institution, or of agreements between the agency and the institution. In a recent case (SEC vs. Youmans, 543 F.Supp. 1292 (E.D. Tenn. 1982)), a federal district court held that Hamilton Bancshares Inc. should have disclosed criticisms contained in the Comptroller of the Currency's 1974 examination of Hamilton National Bank, and should have disclosed restrictions imposed on the bank by a written agreement between the Comptroller and the bank. Although such disclosures may be helpful in protecting potential investors, this type of disclosure is made too late to induce the institution to avoid risk-taking.

These considerations illustrate the fact that financial institutions are different from other corporations. As Robert Winter and Barbara Anderson (1982, 16) point out:

> Financial institutions also face disclosure issues in a context that is different in important respects from most other companies.... The type of regulatory process that generates examination reports and detailed enforcement agreements covering business and accounting matters simply does not exist for most business. The typical industrial company does

> not have a government agency insist that it change management or disclose that it must raise a specified amount of capital by a certain date. Financial analysts may reach such conclusions based upon their review of the company, but the company itself need not publicize those views and, when known, they do not carry the imprimatur of government.

One reason for treating financial institutions differently with respect to disclosure is a concern not only for stockholders and potential investors, but also for encouraging development of market discipline. Although disclosure may be more destabilizing for financial institutions than for other companies, public benefits accrue from increased market discipline.

This discussion of the effect of disclosure on stockholders has ignored the fact that most thrift institutions are mutual in form and have no stockholders; disclosure has been analyzed solely in terms of its potential contribution to the development of market discipline. With respect to market discipline imposed by uninsured depositors, disclosure plays the same role for mutual and stock institutions: it contributes to the useful pressure of market discipline at the potential cost of inducing destabilizing deposit flows. Because market discipline imposed by stockholders of mutual institutions cannot exist, disclosure cannot contribute to it. Disclosure of information concerning mutual institutions may be desirable or appropriate for other reasons, but disclosure for mutual S&Ls is not related to the hope of stockholder pressure for conservatism. This lack of stockholder discipline in mutuals is one reason for preferring the stock form of organization.

SUMMARY

When it is effective, market discipline may reduce the tendency of those controlling an institution to engage in excessively risky operations. But disclosure of adverse information in the presence of uninsured depositors who feel that they are at risk can lead to liquidity crises that make the problem worse and a satisfactory resolution more difficult.

There are reasons for believing that uninsured depositors are unlikely to be a significant conservative force in S&L operations: Even with a reduction in the level of deposit insurance coverage, nearly all S&L depositors are likely to be insured, and S&Ls will probably be able to obtain needed amounts of insured deposits with the aid of brokers. In addition, uninsured depositors generally believe that they can remove funds without loss in case of a problem. Although disclosure is necessary to make market discipline effective, it cannot create market discipline in the absence of depositors at risk.

It does appear, however, that market discipline can be useful because of its effect on stockholders and potential investors. Investors--particularly investors in the stock of financial institutions--are probably adverse to risk. Full disclosure is necessary to make such market discipline effective. With respect to stockholders, disclosure cannot be a destabilizing force.

One approach that follows from this analysis is to adopt a policy of 100 percent insurance coverage, combined with full disclosure. To the extent that this action would leave institutions with a preference for risk-taking beyond what is considered socially optimal, risk-taking can be discouraged by regulation and supervision, as now, or through a system of risk-related deposit insurance premiums. This policy minimizes the danger of liquidity crises, provides full protection to the public, allows for market discipline imposed by stockholders, and permits the insurance agency to adopt the optimal procedure for handling failures when they occur.

The market discipline imposed by stockholders might be supplemented by increased market discipline imposed by longer term uninsured depositors. A system could be devised in which short-term deposits were insured in full, while longer term deposits received only partial coverage. That coverage could be limited to an amount less than $100,000, or it might involve co-insurance, with deposits above a certain amount provided with only 50 percent insurance. Because many S&Ls would have an incentive to acquire longer term deposits (because of their long-term asset portfolios), they would be willing to offer higher rates for such deposits. This may develop some market response. Encouragement for such deposits could be created through regulation of reserve requirements. If lower reserve requirements applied to longer term deposits, S&Ls could afford to offer higher rates for them. If S&Ls found it desirable to attract such deposits in large denominations and potential depositors recognized that they were at risk, some market discipline could be generated.

This scheme raises a problem: S&Ls might, through brokerage, acquire large amounts of longer term deposits in smaller (fully insured) denominations. The computer and communications technology capability of the brokerage industry is such that small denominations can be packaged into large amounts at relatively low cost. It is important to find a means of frustrating this ability to overcome the legal limits on deposit insurance coverage without interfering with useful market innovations.

SECTION III

MAINTAINING PUBLIC CONFIDENCE

(395)

The Federal Savings and Loan Insurance Corporation (FSLIC) fund grew in the crisis period of 1981 and 1982, although the average cost of assistance in those years was six times the level of 1980. This reflects the fact that losses to the fund are more than a function of the number of insured savings and loan associations (S&Ls) that fail. The actual relationship between the number of S&L failures and losses to the fund is more complex; among other factors, the number of failed institutions, the method of resolution chosen by the FSLIC, and the timing of FSLIC actions affect the size of the final FSLIC fund loss.

The FSLIC has a variety of choices in dealing with an S&L in difficulty. If an S&L closes its doors because it cannot meet its obligations, the FSLIC must pay out insured depositors and seek recovery through liquidation of the assets of the failed institution. Under the National Housing Act, however, the FSLIC can make contributions or loans to a failing institution, can purchase assets from it, or can provide assistance in any of these ways to facilitate a merger of the troubled institution with a healthy one. Usually one or a combination of these approaches will prove cheaper than liquidation. The size of the loss, then, depends in part on the skill and judgment of FSLIC management.

Because of public confidence in the federal deposit insurance system, insured troubled institutions rarely face a dramatic outflow of deposits, even when there is general knowledge of their problems. An institution that is technically insolvent can operate indefinitely as far as the public is concerned; this means that it is difficult to define "financial failure" precisely. In addition, the financial condition of most failing institutions deteriorates gradually, rather than as a result of a sudden shock. The FSLIC thus has wide latitude in timing its actions. At the extreme, if deteriorating S&Ls were closed before their economic value declined to zero, losses to the FSLIC would be negligible even if many institutions failed.

THE NUMBER OF TROUBLED S&Ls

The causes of S&L failures have important implications for the soundness of a deposit insurance system. An industrywide insurance system is an inexpensive means of spreading risks from factors related to individual institutions, such as fraud, incompetent management, or poor credit decisions. Such problems will cause a limited number of institutions to fail each year, and there is little difficulty in setting insurance premiums that will result in a fund large enough to meet the demands on it. However, if failures result from economywide factors, such as a depression with severe credit losses or a rapid escalation of interest rates, a larger fund may be needed; the insurer could otherwise be overwhelmed by a large number of failures at the same time.

There are several defenses against failures resulting from either individual or macroeconomic factors. Owners and managers of savings and loan associations have an incentive to avoid failure; should this prove insufficient, there is also a system of regulation and supervision. Regulation has restricted the activities of S&Ls, partly to keep them primarily home mortgage lenders, and partly to keep them out of activities viewed as excessively risky (for example, there are restrictions on S&L investment in common stock). Regulation has also helped to protect S&Ls; in the absence of interest rate ceilings, for example, it is likely that there would have been many more S&L failures between 1966 and 1980. In the past few years, however, the spread between the rate ceilings of the 1970s and market rates has been too great to be maintained, particularly once money market mutual funds offered relatively small investors a convenient means of obtaining market rates. Thus the effectiveness of rate ceilings in protecting S&L solvency has been substantially eroded.

The system of supervision and examination is effective in gathering information and solving the problems of individual institutions. Most important, at least with stock associations, is the opportunity to persuade or compel a potentially troubled institution to increase its capital. Capital requirements may be the most effective means of reducing risk to the deposit insurance system, even if it is not possible to define "capital adequacy" with any precision. Capital serves as a cushion for the insurance fund in the case of S&L problems; any losses are borne by equity capital before the FSLIC fund is affected. However, operating losses caused by continued high interest rates have depleted this capital in many S&Ls, which now have little cushion against future problems.

Nearly all problem S&Ls are weak because the interest costs of their relatively short-term liabilities are not matched by yields on their longer term assets. Recent declines in interest rates have substantially improved the condition of many S&Ls, and the remaining problem institutions would benefit substantially by a further drop in rates. The probable effect of various interest rate levels on the savings and loan industry is thus pertinent to the question of the adequacy of the FSLIC fund.

Simulation Model

The Federal Home Loan Bank Board (FHLBB) has developed an accounting simulation model that allows a projection of the condition of the savings and loan industry given any assumed interest rate level. The model is designed to show the effects of interest rate changes on S&Ls; it does not account for factors such as defaulted loans, poor management, and off-balance-sheet activities such as forward commitments. Two scenarios under the FHLBB model are presented here. One represents a rather unfavorable future for the thrift industry, with interest rates returning to their 1981 levels; the other represents a more favorable interest rate forecast recently used by the Office of Management and Budget (OMB). These are, obviously, neither the most favorable nor the worst outcomes that could materialize.

The unfavorable scenario posits a 13.5 percent U.S. Treasury bill rate and a prime rate of 17.25 percent. (Although these rates are significantly higher than those now prevailing, they are lower than some actual rates of the past two years.) Under this scenario, the S&L industry would continue to suffer losses through 1984, with the rate of losses increasing. During 1983 and 1984 a total of 1,290 savings and loan associations, with total assets of about $284 billion, would exhaust their book net worth. Even if final FSLIC losses were a very small fraction of this asset total, the losses would clearly exceed the available resources.

A different picture emerges from analysis of the August 1982 OMB economic forecast. The OMB expects interest rates to decline through 1983 and 1984, with the Treasury bill rate at 9 percent in the first quarter of 1983 and the prime rate at 11.75 percent. Under this scenario, the industry would return to profitability by the second quarter of 1983, with earnings rising each quarter through 1984. Many S&Ls would continue to have severe problems with these interest rates, but fewer than 200 would exhaust their net worth during 1983 and 1984. The total assets of these institutions would be less than $40 billion. This figure is well within the scope of the FSLIC's existing resources and techniques.

The implication of these comparisons is clear: the FSLIC fund, with its annual increments from interest and premium income, is large enough to handle the losses that are likely under a continuation of current, or modestly increased, interest rates. On the other hand, a return to the record level of interest rates that prevailed in 1981 and early 1982 might precipitate a crisis in the industry that could not be handled within the existing system under traditional assistance techniques.

The simulation results do indicate that, in the absence of permanently low and stable interest rates, the savings and loan industry faces serious problems. Given this knowledge, the primary task of this study is to examine the long-term desirability of changes in the structure of the federal deposit insurance system, considering how such changes may induce altered behavior in savings and loan associations.

Traditional Sources of Risk

It is important that the current problems of the industry not dominate the long-term design of the system. The current condition of the industry, however, may raise legitimate concern about the length of time it may take to implement reforms. Such concern is partly based on the fact that it is difficult to analyze the current risks to the deposit insurance fund, and it is obviously more difficult to predict future risks. Several considerations lead to the conclusion that risks in the future will be different from those in the past. Although it is impossible to quantify these factors, it is nevertheless useful to consider them explicitly.

It is now easy to recognize that the posture of the savings and loan industry, with long-term, fixed-rate mortgages funded by short-term deposits, is a very risky one. However, it was not unreasonable to ignore interest rate risk until the late 1970s. There were short periods of sharply rising rates (as in 1966 and 1969), but the general stability of interest rates led many to the conclusion that "borrowing short and lending long" was an appropriate policy. The economy was stable, the inflation rate was relatively low, and Federal Reserve policy stressed interest rate stability. Most important were the fixed deposit interest rate ceilings that reduced the cyclical volatility of the cost of funds to S&Ls and thus stabilized S&L profitability.

During the late 1960s and the 1970s, deposit interest rate ceilings shielded S&Ls from some of the effects of rising interest rates. If market interest rates had not remained high for so long after 1978 and if money market mutual funds had never developed, rate ceilings could have continued to be a successful means of coping with rate volatility. In the actual circumstances, however, deposit rate ceilings served only to delay the industry's adjustment. Now, after substantial decontrol of deposit rates, nearly all S&L deposits are sensitive to market rates, and the vast majority have a maturity of six months or less. If rates rise sharply in the future, the effects of that rise in rates will be reflected more quickly in the earnings of S&Ls.

Fortunately, many S&Ls have considerably improved their ability to deal with rising interest rates. Although variable-rate mortgages will not be the predominant component of S&L portfolios for some time, most S&Ls are now offering such mortgages, and some make only such mortgages. Savings and loan associations also have the opportunity to acquire shorter term assets, including consumer, construction, and business loans. Consumer loan rates are not very flexible, and their typical maturity does not qualify them as truly short-term instruments, but they do represent some improvement in rate sensitivity compared with long-term, fixed-rate mortgages. Most S&Ls have just recently acquired business lending powers, and the volume of such loans will not soon become large. Nevertheless, because such loans are typically made on a floating-rate basis or have short maturities, their growth will further aid in improving the ability of S&Ls to match the rate sensitivities of their assets and liabilities.

In addition to these changes in asset structure, some associations are hedging their interest rate risk exposure in the financial futures and debt options markets. These markets offer a conceptually ideal means of handling interest rate risk exposure. However, the substantial complexity of designing and operating a hedging program will be an obstacle to widespread use of this technique.

An additional consideration is the improved flow of information to S&L managers that will result from planned changes in the Federal Home Loan Bank Board's reporting system. It has long been recognized that an increase in interest rates meant real economic losses to S&Ls, but accounting practice has not required current recognition of such losses. More important, timely information on the exact size of such losses has not been available to the managers and directors of the S&Ls, to the FHLBB, or to the FSLIC. In some cases serious losses have not been recognized until the S&L was in a substantial negative net worth position (measured in market values). Better information will enable the FSLIC to make better decisions on the handling of problems; it will also improve the ability of S&L managers to diagnose problem areas and to avoid them.

The importance of improving the information given to the FHLBB is separate from the issues of appropriate accounting principles for S&Ls and of public disclosure of S&L financial information. Accountants may or may not conclude that S&L assets and liabilities should be reported on a market value basis, and disclosure regulations may or may not require S&Ls to disclose market value data or the maturity structure of their portfolios. The FHLBB should nevertheless obtain the information necessary for its own purposes.

New Sources of Risk

As noted, S&Ls are reducing the average maturity of their asset portfolios by engaging in activities that involve shorter-term loans. However, although the shorter maturities of consumer loans and business loans reduce S&L exposure to interest rate risk, these loans involve a greater credit risk. Credit losses on home mortgage loans are extremely low--borrowers give first priority to maintaining possession of their homes, down payments deter default, private and federal mortgage insurance provide protection even when borrowers do default, and rising home prices have ultimately justified many lending mistakes. These factors are less significant for consumer and business loans. The record of commercial bank lending in these areas shows substantially larger credit losses in these activities than in mortgage lending.

Moreover, these activities are new for S&Ls, and learning may prove expensive. Consumer installment lending requires a large volume of business to cover the fixed costs involved. Some S&Ls will seek volume by purchasing loans in the secondary market from retailers, but most reputable firms that originate and sell loans already have long-standing relationships with commercial banks. Building sufficient volume in this business may require accepting greater credit risks.

Business lending holds more dangers for the newcomer. Savings and loan associations lack staff experienced in this area; many, knowing this, are seeking to hire experienced commercial bank officers. But there is no surplus of either qualified commercial loan officers or of good-credit-quality business borrowers without well-established banking connections. In the long term, S&L entry into consumer and business lending will benefit both the institutions and the economy, but there will be risks in the short term.

Recent legislation has also broadened S&L powers to participate in real estate development. This activity has been profitable to savings and loan associations in states that have permitted it, and it is closely related to S&Ls' traditional area of expertise. Nevertheless, either bad management or bad luck, or both, in this business can result in substantial losses.

Savings and loan associations are beginning to exercise these new powers at the same time that they are facing the need to compete without the protection of deposit interest rate ceilings. In addition, the current U.S. economic outlook is rather unfavorable. The economy is growing more slowly than in the past, and most forecasts predict that this slow growth will continue. The economy may be becoming less stable; in any case, interest rates appear to be less stable.

A favorable aspect of the current economy is the decline in the rate of inflation--but even that development is a mixed blessing for the savings and loan industry. The decline in interest rates that has accompanied the decline in the inflation rate is most welcome, but inflation has played an important role in bailing lenders out of mistakes in real estate lending. If housing prices do not rise each year, S&Ls may face an increase in credit losses. Such uncertainties about the economy discourage the sanguine view that the savings and loan industry will face fewer problems in the future than in the past.

Normally, one would expect financial institutions to appraise the risks associated with new activities and the economic climate and to make decisions accordingly; however, the financial condition of many S&Ls raises additional problems. Operating losses in the past couple of years have eroded the net worth positions of S&Ls, reducing their capital cushion as they enter new fields of business activity. Many institutions are simply too weak to restructure their operations toward new business endeavors without assuming undue risks. Some S&Ls may take these excessive risks because they believe that their weakened financial condition leaves them no choice--that is, they believe that they must restructure to survive.

This problem is directly related to federal deposit insurance. Financial institutions generally operate in a conservative manner, because their owners' capital and their managers' jobs are at risk. In most businesses, a firm that loses its capital cannot obtain funds to continue operations. Federally insured S&Ls can, and do, stay in business even after their capital is depleted because their creditors (depositors) have confidence in the deposit insurance system. Moreover, not only can these institutions stay in business, they can also obtain the funds they need to undertake risky ventures.

Savings and loan associations have been known to face insolvency because of mistakes and unfavorable economic developments even when attempting to operate conservatively and avoid risk. Now, because of their weakened condition, some S&Ls have every incentive to take excessive risks, and this may lead to increased problems in the future.

New techniques and instruments. This threat to the adequacy of the FSLIC fund has been increased by new financial techniques and instruments based in one way or another on deposit insurance. These developments, fostered by the virtual removal of deposit interest rate ceilings, mean that the deposits attracted by a savings and loan association are no longer limited by the size of its local market and its ability to provide a convenient depository for local residents. An S&L that is willing to pay a rate higher than the market interest rate can attract virtually any amount of funds. For example, a broker can distribute deposits on a national basis to customers who may never have heard of the issuing S&L,

but who are relying on the FSLIC to make good in case of failure. Deposits insured by the FSLIC can be distributed on either a retail or wholesale basis; that is, a broker can sell certificates of deposit to individual customers, or can package the $100,000 certificates of deposit of a number of S&Ls into large blocks to be sold to institutional investors.

A more complicated and ingenious device is the municipal bond backed by certificates of deposit. Under this scheme, a tax-exempt housing authority (or other public agency) sells bonds in amounts of up to $100,000 to the public. The funds are turned over to a savings and loan association or commercial bank, which issues a certificate of deposit to the bond issuer to serve as collateral for the bonds. The association or bank then makes the loans that the public agency would have made. The bondholders are relying for their security not only on the project being financed and the creditworthiness of the local housing authority, but also on the federal deposit insurance system.

This arrangement has many undesirable features. It distorts the municipal bond market, crowding out potential borrowers who may have better credit ratings than the municipalities. Their credit ratings are, in any case, lower than that of the FSLIC. More important is the fact that a substantial amount of new risks are being underwritten by the FSLIC. This may not be the type of risk that federal deposit insurance is intended to secure.

It is impossible to be confident that the serious risks faced by the FSLIC will not increase in the future. An appropriate design for the deposit insurance system must recognize the possibility, if not the probability, that problems of similar magnitude will occur again.

HANDLING TROUBLED INSTITUTIONS

The losses suffered by the FSLIC depend very heavily on the means the FSLIC chooses and the skill it exercises in resolving problems. The FSLIC has an order of priorities for its choice of methods, which is also linked to the timing of its actions.

When an S&L has significantly depleted its net worth, a simple solution is for the owners of that institution to put in additional capital or to raise additional capital in the market. This approach is more feasible for stock savings and loan associations than for mutual associations. Mutual associations do not have stockholders with an investment to protect, and conditions have not favored sales of mutual capital certificates. In some cases, conversion of the mutual association to a stock association may help to resolve the problem; however, it has also been difficult for stock associations to sell stock in the market at prices that avoid substantial dilution for existing shareholders.

There is no cost to the FSLIC fund when sufficient additional capital is available to a troubled institution. There are other solutions that require no assistance by the FSLIC. In the simplest such case, an otherwise healthy S&L might face a liquidity problem and need some short-term funds. If the S&L is sound, its federal home loan bank can provide nonsubsidized funds to resolve the problem. Actually, such instances are infrequent; a sound, insured S&L has little trouble obtaining funds from the market and is unlikely to face a substantial deposit outflow.

Many potential problems are resolved, at no cost to the FSLIC, by mergers arranged by the institutions themselves. If the troubled institution is unable or unwilling to arrange a merger without FSLIC involvement, the FSLIC may be able to arrange such a merger without any cash assistance or with only marginal assistance. The ability to arrange a merger involving little or no assistance from the FSLIC depends on the timing of FSLIC involvement. If action can be taken before the institution's economic net worth has been depleted, such arrangements are more likely than if the economic value of the S&L's assets is much less than the value of its liabilities.

Once a serious problem is recognized, the FSLIC must decide whether to keep the ailing institution in business, to merge it into another institution, or to liquidate it. The FSLIC has a number of options in arranging mergers and has a variety of ways in which the troubled institution can be kept in operation.

In general, FSLIC actions are subject to a cost test. The merger of a failing institution with a sound one generally is less costly to the FSLIC than a liquidation. The failing institution may have some below-market-rate deposits or a structure of offices that are of value to a prospective acquirer. Such an institution would be willing to pay a higher price, over book value, that reduces the loss that would have been borne by the FSLIC in a liquidation. The merger, in effect, preserves the "going concern value" of the failed institution.

An important effect of the assisted merger is that it fully protects all creditors of the institution, not just insured depositors. This is clearly an advantage to uninsured creditors; however, this means of handling problems impedes the development of greater market discipline in the S&L business. Uninsured depositors will not choose an S&L on the basis of its perceived soundness if they expect to be protected fully if the institution fails.

A more attractive method, from the point of view of the supervisory and insuring agencies, would be an arranged merger in which uninsured creditors shared the loss with the insurance agency. The FSLIC recently handled a failing institution in such a way that insured depositors received immediate compensation (the insured deposits were assumed by another S&L), while uninsured creditors are waiting for liquidation of the failed institution's assets by the FSLIC. This was possible because all the assets on which the uninsured creditors have any claim are being kept in receivership. Legislation to provide for more general power to withhold or delay full payment to uninsured depositors is clearly worthy of consideration.

The Garn-St Germain Depository Institutions Act of 1982 defines certain priorities for FSLIC actions. When the merger offer that requires the least FSLIC assistance comes from an institution that is not an in-state insured institution or an in-state savings and loan holding company, the FSLIC must let offerors who were within the lesser of 15 percent or $15 million of the initial lowest acceptable offer submit a new offer. Should a reoffer result in a tie between bids, transactions are authorized in the following order of priority: between depository institutions of the same type within the same state; between depository institutions of the same type in different states; between depository institutions of different types within the same state; and between depository institutions of different types in different states. With regard to tie offers from different states, the FSLIC must give priority to offers from adjoining states. In the case of minority-controlled institutions, the FSLIC must also seek offers from other minority-controlled institutions.

Alternatives to Merger

Although it may be preferable to merge an ailing institution with a healthy one, economies can also result from joining two or more weak institutions. A conditionally approved supervisory merger (CASM) allows two weak institutions to develop a plan for recovery without the need for further FSLIC assistance. Such CASMs may be approved when they will result in the ability to maintain positive net worth for 36 months at the current rate of losses.

The "phoenix" is a supervisory merger of very weak institutions that do not meet the three-year viability test for a CASM, but that do demonstrate a possibility of long-range recovery. The combined institution must agree to accept additional control by the FSLIC, including new directors or managers and FSLIC power to arrange a further merger.

The FSLIC has traditionally tried to minimize the volume of assets it must liquidate; it therefore encourages bidding S&Ls to take over most or all of the failing institution's assets. This requires each participating S&L to examine carefully the assets it is bidding for--a time-consuming process that restricts the number of potential bidders. However, the FSLIC is then able to consider bids based on various means of structuring a deal and may be able to come up with an arrangement that is well suited to a particular bidder. The FSLIC is able to choose among the bids on the basis of the least expected cost to the fund.

These options have implications for the adequacy of the FSLIC fund. The federal deposit insurance agencies have found that the prices offered by acquiring institutions tend to rise with the number of institutions participating in competitive bidding.

Maximizing the number of bidders for failed S&Ls involves some important public policy issues. A higher price can generally be obtained if out-of-state S&Ls and bank holding companies, both in-state and out-of-state, are allowed to bid. In many cases a bank holding company would be willing to offer a substantially higher price to acquire an S&L in a state that the company cannot enter by any other route. The recent expansion of S&L powers has made this more attractive. The price reflects the fact that bank holding companies cannot now acquire S&Ls except in emergencies (although the Federal Reserve Board may have the legal authority to allow such acquisitions under Section 4(c)(8) of the Bank Holding Company Act). The FSLIC has so far taken advantage of this opportunity in only one case, the acquisition of Fidelity Savings and Loan of California by Citicorp.

The FSLIC can also sell a failing S&L to a nonfinancial corporation; there are no restrictions on the nonfinancial activities of savings and loan holding companies that own only one S&L. National Steel Corporation, for example, was able to acquire three failing S&Ls and merge them. This approach offers the FSLIC some opportunities to reduce the cost of assistance.

It is not clear what criteria a mutual S&L should use in determining whether to bid to acquire an ailing institution. In some cases, of course, economies of scale may result from the consolidation. However, management may have an interest in acquiring additional assets because salaries are related to the size of the association, and it is difficult for the FSLIC to be sure that a particular merger will result in increased economic efficiency. A stock association, on the other hand, will be concerned that a proposed merger benefit its stockholders. In general, that can occur only if the merger improves economic efficiency.

Failing mutual associations may be easier to deal with than stock associations. The shareholders of a stock institution that is the subject of a supervisory merger can be expected to object if the merger eliminates or dilutes their ownership. The managers of mutuals may lose from a merger, but they are less able to take legal action to prevent a supervisory merger.

Another question involves how the managers of failed S&Ls should be treated when FSLIC assistance is required to arrange a merger. In a number of cases, S&L and mutual savings bank managers have complained that a punitive approach was taken by the federal insurance agencies. Because of the cause of most thrift institution failures--high interest rates forcing losses by institutions forced to make long-term, fixed-rate loans--some have argued that such failures are not always the result of management ineptitude. Nevertheless, there are reasons for insisting on a change in management as a condition for FSLIC assistance. The willingness of S&L managers and owners to arrange mergers with sound institutions without FSLIC assistance depends to some extent on their perception of the treatment they can expect from FSLIC if they do not resolve the situation voluntarily. If a change of management inevitably accompanies FSLIC assistance, there is a strong incentive to resolve problems in a manner that does not require FSLIC aid.

TIMING OF FSLIC ACTION

Most savings and loan association failures occur because of prolonged operating losses, which deplete net worth (measured in book values). One could also say that the S&L's net worth, in market value, declines as interest rates rise. In any case, unless there are sudden, very large changes in interest rates or catastrophic loan losses, net worth will decline gradually. If the FSLIC steps in before market value net worth declines to zero, it can arrange a merger or liquidate the association with no loss. If such a policy were adopted, loss to the insurance fund would be independent of the number of S&Ls that actually fail.

Financial failure is thus difficult to define. Zero book net worth is not an impenetrable barrier to continued operation. Because insured depositors are not relying on the resources of the S&L for protection, it makes little difference to them whether net worth is positive or negative. Although an S&L with negative net worth may find it difficult or impossible to obtain uninsured funds, it is not limited in its ability to obtain insured deposits.

The timing of the action to merge or close an S&L in this position is not totally at the discretion of the FSLIC. Under current accounting principles, S&Ls need not recognize changes in the market value of assets. The FSLIC may not be able to close an S&L whose market-value net worth is zero if it is meeting regulatory requirements in terms of book values. Ensuring that the FSLIC can close an S&L before its economic net worth becomes zero may require a change to market value accounting.

However, it is not clear that closing an institution whose net worth is zero, although it would minimize the loss to the insurance fund, is appropriate public policy. There are legitimate considerations that argue for allowing some S&Ls to continue operating even if they are losing money on a current basis, and even if they have negative net worth. Many S&Ls with negative net worth can be expected to be profitable in the future, on the basis of yields and costs currently prevailing in the market, given their existing location, organization, and management.

This does not mean that all troubled S&Ls should be allowed to operate indefinitely. Savings and loan associations that are unlikely to become profitable again should be closed or merged as soon as the depth of the problem is recognized. However, there is no certain method of determining whether a troubled S&L is likely to become profitable. If an ailing S&L is closed prematurely, the public is denied a source of financial services, the FSLIC probably must make an immediate outlay of funds, and final FSLIC losses will be greater than necessary. On the other hand, if a permanently unprofitable S&L is allowed to operate with negative net worth, the loss to the FSLIC may be even greater.

The FSLIC can support a troubled S&L by using net worth (or income capital) certificates. This allows the FSLIC to exchange its obligations for those of an S&L with low net worth. The FSLIC is already at risk in case of the S&L's failure; net worth certificates do not significantly increase FSLIC exposure. The use of these certificates does have some market effects. An S&L with negative book net worth is often unable to attract uninsured funds. Net worth certificates provide additional protection for uninsured creditors, and thus improve the ability of the S&L to tap this market.

THE FUTURE ADEQUACY OF THE FUND

The FSLIC has demonstrated its ability to handle financial catastrophe by its success, in the crisis of the past few years, in avoiding both financial disaster and any loss of public confidence in deposit insurance. But this demonstration is not wholly reassuring, because conditions under which the FSLIC fund would not be adequate can readily be imagined.

A full answer to the question of FSLIC fund adequacy in the face of catastrophic financial failure requires a review of the purposes of federal deposit insurance and the role of FSLIC and other government institutions. During the 1920s and early 1930s it was possible for a sound financial institution to fail because of sudden, massive withdrawals by depositors in response to rumors or doubts about its financial condition. Federal deposit insurance for commercial banks was developed to deal with such liquidity problems. Although the origin of deposit insurance for S&Ls involved other concerns as well as liquidity problems, the position of S&Ls in financial markets has come to resemble that of commercial banks. Today, the role of deposit insurance in maintaining public confidence in the financial system may be its most important function.

Deposit insurance has been totally successful in maintaining stability; liquidity crises have not developed even in the case of institutions known to have serious problems. But the public confidence engendered by deposit insurance must be supported by rational government economic policy. The deposit insurance funds may not--and, it is generally agreed, need not--be adequate to deal with a drastic deflation and depression of the kind that occurred in the 1930s. (Monetarists argue that the collapse of the Great Depression was due to Federal Reserve policy that caused or allowed a very large decline in the money supply. Those who do not accept this interpretation nevertheless agree that it is the responsibility of the federal government to prevent such a collapse of the economy.) Such catastrophes are more appropriately a general obligation of the government than of an insurance fund drawn from user fees.

The recent problems of the savings and loan industry, and so of the FSLIC, have resulted from the effect of extraordinary interest rate movements on a vulnerable industry. This could perhaps have been handled with minimal losses to the insurance fund had the FSLIC closed S&Ls as soon as interest rate changes depleted their net worth in terms of market values. However, such a policy would have resulted in the closing of nearly every S&L in the country.

The deposit insurance system has functioned well in the past, and has come through the crisis of recent years with public confidence maintained and with the assets of the fund virtually unimpaired. However, it is not only the size of the fund and its premium and interest income that ensure its ability to handle future problems. The FSLIC's ability to handle problems depends also on its authority as a government agency, which enables the FSLIC to resolve problems more expeditiously than a private insurer could.

There are a variety of ways by which any perceived inadequacy of the insurance fund could be rectified. First is the traditional regulatory response to increased institutional risk; increase regulation. It would be feasible to regulate the interest rate risk position of S&Ls, perhaps by limiting the maturity of mortgage loans or restricting the use of fixed-rate mortgages. Credit risk could be reduced by limiting S&L entry into consumer and business lending. Savings and loan associations could be encouraged to raise capital by limiting the exercise of new powers to S&Ls that meet higher capital requirements. However, apart from the merits of any particular regulatory proposal, this approach runs counter to the trend toward less regulation of financial institutions.

Second, the adequacy of the insurance fund could be improved by reducing the level of FSLIC coverage. A key factor is whether any change with respect to FSLIC coverage would be matched by a change in FDIC coverage of commercial bank and mutual savings bank deposits; a reduction in FSLIC coverage that is not so matched would lead to a substantial transfer of deposits from S&Ls to commercial and mutual savings banks. A matched reduction would be countered by brokers' efforts to package deposits, but if the reduction in coverage were large enough (for example, to $20,000), a significant drop in the proportion of insured deposits could be produced. This change would increse the adequacy of the FSLIC fund to the extent that it would reduce the total insured deposits of savings and loan associations, cause FSLIC procedures of dealing with failing institutions to change, and increase market discipline (which reduces association risk-taking). However, the efficacy of this approach is open to serious question. It may be beneficial to eliminate the de facto coverage of large institutional deposits created by current FSLIC assistance procedures, but an explicit reduction in the $100,000 insurance limit may have a net adverse effect in consumer savings markets.

Third, the adequacy of the fund could be enhanced by improving the capital adequacy of insured S&Ls. The net worth of S&Ls and the financial resources of the FSLIC fund offer a dual protection to savers. The net worth of S&Ls initially absorbs operating losses. If the S&L's net worth is insufficient, the FSLIC's fund and other resources are used to deal with the problem. Improving the capital adequacy of S&Ls would thus improve the adequacy of the FSLIC fund by reducing the likelihood of S&L failures.

Fourth, improving the quality and extent of information on the economic value of the S&Ls that is available to the FSLIC would enhance the FSLIC's ability to handle problems. These improvements would include information on the current market value of the S&L's assets and liabilities and the magnitude of the interest rate risk exposure of the institution. Such improved information would enable the FSLIC to improve the timing of its actions and the sophistication of its selection of a financial assistance procedure.

Fifth, fund adequacy could be enhanced by providing additional assistance techniques to the FSLIC. At present, there is, to some extent, de facto coverage of uninsured creditors. Because of a variety of economic factors, the FSLIC utilizes merger-like methods most of the time to handle failing S&Ls. Uninsured creditors are usually made whole. If FSLIC had the flexibility to protect insured savers and to reject the claims of uninsured creditors, it could reduce the cost of merger-like methods and so improve the adequacy of the fund.

Sixth, the adequacy of the fund could be improved by making premiums risk-sensitive. Relating insurance premiums to the risk taken by individual institutions may encourage institutions to reduce their exposure to risk. The fund would be made more adequate by reducing the risk exposure of the fund rather than by supplementing the resources available for dealing with failing S&Ls. Relating premiums to risk would not necessarily affect the total amount of premiums collected by the FSLIC.

Seventh, the level of insurance premiums could be raised. To the extent that such an increase generates additional income to the FSLIC, it represents an additional user fee for the savings and loan industry. (It is appropriate to view this as a user fee because the fund is used to assist S&Ls to recover or to protect the customers of closed S&Ls. In either case, S&Ls benefit from FSLIC protection.) However, the industry should not be expected to provide a fund adequate for protection against a general collapse of the economy; it is more appropriate to use the general revenues of the government to spread the cost of such a collapse across society. There are at least two ways of doing this: increase the credit available to the FSLIC from the U.S. Treasury or have the Treasury guarantee deposits.

Eighth, the fund could be made more adequate by hedging the risk to which it is exposed. The currently dominant source of S&L risk is interest rate risk caused by the maturity mismatch of assets and liabilities. Savings and loan associations could reduce this risk through the financial futures market. If S&Ls choose not to hedge this risk, the FSLIC could do so in the debt options market. Although the debt options market is thin in comparison to FSLIC hedging needs, they will develop in time, especially if the FSLIC becomes an active participant. One complication to this approach is that option hedging involves a significant expense that may make an increase in insurance premiums necessary. It would be cheaper for S&Ls to reduce risk exposure through futures market hedging than for the FSLIC to hedge its exposure through the debt options market.

Ninth, the fund could be made more adequate by changing its financial management practices. In earlier years, the primary causes of S&L failure were default risk and fraud; interest rate risk played a minor role. Consequently, the FSLIC fund was invested in securities with an average maturity of three to four years. That three- or four-year average maturity is now inappropriate; the average maturity of the fund should be very short. If the cash needs of the FSLIC are highest when interest rates rise, the

FSLIC should avoid holding long-term securities that would have to be liquidated at a loss to cover assistance needs. The FSLIC has already taken action to reduce the maturity of the fund; a continuation of this policy appears to be warranted.

SUMMARY

The FSLIC has been able, through a variety of techniques, to minimize the cost of handling weak S&Ls. The FSLIC has generally been able to arrange mergers of failing S&Ls more cheaply than liquidation and with less disruption of financial services. Because of these policies, even the extraordinary losses of 1981, 1982, and 1983 have not significantly depleted the fund. It is recognized that FSLIC losses could be minimized by prompt closing of weak S&Ls; losses have been higher than they might have been because of the policy of keeping weak institutions in operation. The alternative policy, however, might well have caused substantial disruptions in the nation's financial markets.

Despite the success of the past, it is impossible to be sure that future losses will be within the capacity of the fund. In assessing adequacy, however, it is plain that the techniques available to the FSLIC to arrange mergers and prevent failures are fundamentally more important than the size of the fund. More important still is the place and authority of the FSLIC as an entity of the federal government.

SECTION IV

PRICING RISK

(429)

In the past few years, increased interest rate volatility, expanded savings and loan association (S&L) asset and liability powers, and a societal preference for deregulation of financial institutions have expanded the range of risk that may be borne by institutions. Because the Federal Savings and Loan Insurance Corporation (FSLIC) insures these institutions, it is studying alternative means of controlling that risk-taking behavior. Because the current system of uniform premiums does not discourage risk-taking, regulations have been used. Risk-sensitive deposit insurance premiums provide an alternative method of controlling association risk-taking by making such behavior more costly. Additionally, risk-sensitive premiums more equitably distribute the costs of insurance among S&Ls by charging higher premiums to riskier firms. Thus the justification for such a premium structure derives from principles of deregulation, efficiency, and fairness.

Risk-sensitive insurance premiums on average can be lower than what uniform insurance premiums would otherwise be because uniform premiums tend to encourage risk-taking, thereby increasing the overall cost of insurance. To the extent that risk-sensitive premiums discourage risk-taking, the average level of premiums can be reduced. Independent judgments may be made that the average level of premiums is currently too low and that premiums should be increased. However, the introduction of risk-sensitive premiums would reduce the need for such increases.

A risk-sensitive premium structure varies premium rates according to types of risk that are both measurable and variable. To be effective, there must be objective, quantifiable measures of risk and the amounts of risk must differ significantly (actually or potentially) among associations. The premium structure need not necessarily reflect all types of risk or perfectly measure risk. Although such accuracy would be desirable, it is not necessary. Risk-sensitive premiums can be useful and effective as long as the measured risk exposure is importantly related to failure, the risk measurement system provides a more accurate risk assessment than the present flat-rate scheme, and the premium structure does not create perverse incentives for institutions to assume other risks that are not used as a basis for premiums.

The Need for Risk-Sensitive Premiums

The provision of deposit insurance is of benefit to the financial institutions, depositors, and the public as a whole. Consumers are spared the information costs of determining which institutions are safe depositories for their funds; the financial system operates more smoothly because public confidence in that system is maintained at a high level. However, by permitting institutions to borrow some of their funds at lower risk-free interest rates that do not take into account possible losses from failure of the institution, deposit insurance encourages institutions to increase risk exposure in two ways. First, because many depositors are no longer concerned about the financial strength of institutions, institutions are encouraged to reduce their ratio of capital to deposits. Second, because they do not have to pay correspondingly higher interest rates on their debt when they invest in higher risk assets, the institutions are encouraged to invest in higher risk, higher return assets.

In effect, deposit insurance reduces market discipline on institutions. Risk-taking is not as heavily penalized. The greater is the proportion of insured deposits, the less is the market discipline. If savings and loan associations succeed in gathering all of their funds in insurable deposits, they will be immunized totally from restrictive market pressures in the form of rising debt interest costs as risk increases. However, risk-sensitive insurance premiums may be used to instill additional discipline to control risk-taking. Scaling insurance premiums to the specific risk exposure of individual institutions effectively serves as a substitute for market discipline.

Risk-sensitive insurance premiums serve a dual purpose. In addition to restoring the effects of market discipline eliminated by deposit insurance itself, they more equitably distribute the costs of the insurance system. It is both economically efficient and fair to charge the benefactors of the insurance in proportion to their contribution in causing insurance payouts. Because the likelihood of payouts is dependent on the risk that institutions will experience reductions in their net worth to zero or below, the riskier an institution elects to become, the relatively greater should be its insurance premium.

Governments in all countries regulate depository institutions because financial crises are worldwide public concerns. These regulations can be either direct controls over operations or controls embodied in prices. Explicit controls include laws and regulations concerning permitted activities, strategies, and prices; reporting to monitor compliance; and onsite examinations to verify compliance. As institutions have become more complex and diversified, regulations have also become more complex and numerous.

The limitations and consequences of attempting to control institution risk and performance by regulation in the United States have become particularly visible in recent years. Dissatisfaction with the implications of influencing institution behavior by regulation has stimulated the search for alternative methods. In recent years, similar experiences in other industries have led to significant deregulation in airlines, motor transportation, and communications. A significant difference exists, however, for depository institutions--namely, the government insures depository institutions and ultimately pays the costs of mistakes made by those deregulated institutions. It is in this setting that consideration is being given to using deposit insurance premiums to replace partially regulation in controlling the risk exposure and behavior of depository institutions.

Risk Management Tools

The FSLIC, through its connections to the Federal Home Loan Bank Board (FHLBB) and the Federal Home Loan Bank System (FHLBS), has many tools at its disposal to manage its risk. Charging a higher premium for higher risk levels would be only one of an arsenal of risk management instruments. Examination and supervision are front-line tools that serve as early warning devices to correct risky situations, and termination of insurance (i.e., closing down the S&L) is the ultimate device to control the fund's liabilities. In addition to examination and supervision, other functions of the FHLBB and the FHLBS can be thought of as FSLIC risk management tools: regulatory limits on business activities; disclosure, capital, and liquidity requirements; chartering; provision of liquidity; and termination of insurance.

Each management tool plays a role in determining the risk of FSLIC payouts. It is obvious that fastidiously watching the financial conditions of S&Ls and closing them before their market value turns negative would eliminate payouts--and risk--from the fund. But because of the practical difficulties of such an approach, many S&Ls are not closed down before a payout is required. The examination and supervision tools have been, and will remain, very useful in detecting and solving problems before they make payouts from the fund necessary, but these instruments are incapable of perfect success under current operating conditions, such as the use of historical cost accounting by S&Ls.

Two major points must be made about the general set of risk management tools that the FSLIC has at its disposal. First, each tool imposes costs on S&Ls. If an S&L begins to experience financial difficulty, the frequency and intensity of examinations can be increased. Both direct costs (examination fees) and indirect costs (such as management's time) increase. Federal home loan bank advances may be more difficult to obtain. The ultimate penalty of a FSLIC takeover becomes more likely as the difficulties increase. In other words, the current risk management system already imposes an increased "premium," both explicit and implicit, for increased financial difficulty.

Second, it may be more efficient to rely on an explicit pricing system for increased risk rather than on a set of implicit prices as embodied in the current approach of regulation, supervision, and examination. The current structure is an inefficient method of controlling risk for two reasons. First, regulations set an essentially arbitrary cutoff on risk-taking. There is little flexibility for individual institutions. As such, regulatory limits on S&Ls tend to be set with regard to the lowest common denominator. Second, supervisory sanctions on associations tend to occur after the fact; after the S&L is in a troubled condition, various implicit costs are imposed. This is a relatively inefficient means of influencing risk-taking decisions. It is more efficient to impose a cost, implicit or explicit, when the risk-taking decision is made rather than imposing that cost after the fact on only unlucky risk-takers.

Risk-sensitive premiums are a possible addition to the FSLIC arsenal of risk-management tools. However, as long as the FSLIC has some other tools that implicitly or explicitly increase the cost to associations that take greater risks, risk-sensitive premiums do not have to be relied on solely to manage risk. This, in turn, sets two conditions. First, premiums do not have to compensate the FSLIC fully for the costs of industry risk-taking. The premiums need be set only in relation to risk; they do not have to be fully compensatory. Second, a risk-sensitive premium system can focus on certain elements of risk. For such a system to be useful to deter risk-taking, it need not address all types of risk faced by the FSLIC.

A moderately graduated premium that focuses even on just one component of risk may be useful in helping the FSLIC to manage risk. A major side effect, however, is the encouragement of aspects of risk not included in the premium formula. As S&Ls are discouraged from one set of risks by the system, they may want to maintain their overall level of risk by substituting those risky activities not discouraged by the system. Although this situation is not likely to create substantive problems, it should be evaluated for any specific proposal. In the event that such side effects do prove significant, the system should be revised to reflect the new character of risk exposure.

In this regard, it should be noted that associations will likely substitute credit risk for interest rate risk in the future. Savings and loan associations will hold more business loans and adjustable-rate mortgages and fewer traditional fixed-rate mortgages. Although the former clearly bear greater default risk, the increase in default risk exposure to the S&L is only a small fraction of the decrease in interest rate risk exposure created by such restructuring of assets.

Sources of Risk

Institutions may fail for a number of reasons. The most prominent are losses from: unfavorable interest rate changes, which cause interest expenses to increase more than interest revenue; defaulted loans, which require a write-down or write-off of assets; and management risk, which refers to strategic mistakes caused by inexperienced and insufficiently skilled managers entering new fields of business activity. Less important are losses from poor management in everyday operations, fraud, and theft.

A commonly mentioned source of risk not included in this list is liquidity risk, which is the risk that an institution may experience customer demand for cash that it cannot meet. Liquidity risk is not cited as a separate source of risk for two reasons. First, the federal home loan banks provide a source of liquidity for S&Ls so that insufficient liquidity need not force an otherwise healthy institution into bankruptcy. Second, liquidity risk is simply one aspect of interest rate risk. If an institution faces a cash flow squeeze, it simply means that the interest rate risk exposure of the S&L has not been properly managed.

Risk-sensitive insurance premiums can be related either to the overall risk level of the institution or to each of the separate risk components enumerated above. Each approach has advantages and disadvantages. The most important advantage to a single risk measure is that resulting risk premium structures are simpler to administer. The measure also incorporates any interdependencies that may exist among the individual risk components. On the other hand, a single measure does not allow the insuring agency the flexibility either to charge different premiums for different types of risks according to its evaluation of their relative importance or to change the relative premium charges on different risk types as their importance is considered to change. Premium structures related to individual risk components would obviously permit this, but only at the cost of greater complexity. In addition, it is necessary to assign relative weights to the individual risk components in order to sum up and obtain the total overall premium.

An important consideration in measuring the riskiness of an S&L is its net worth level. The greater the net worth of the institution, the smaller is the risk of bankruptcy, because net worth serves as a cushion to absorb losses. Thus, the greater is the net worth for a given degree of interest rate and default risk exposure, the less risky is the institution and the lower should be its insurance premium. Net worth is analogous to a deductibility clause in other insurance policies, whereby the insuree bears the cost of the first "x" dollars of losses and the insurer the cost of the remainder. The insured institution bears the cost of losses charged to its own net worth.

The discussion thus far suggests several criteria for an ideal risk-sensitive premium structure. First, the premium structure should establish appropriate relative prices for different types of risk-taking. These prices should reflect the relative costs of these risks to the FSLIC, but should not be so high as to be prohibitive. Second, the premium structure should explicitly include the S&L net worth position because of its ability to absorb losses. Third, the premium structure should be relatively easy to understand. It is critical that managers clearly understand how the premium structure penalizes risk-taking in order for that system to discourage such activity. Fourth, the premium structure should minimize the need for supplemental nonprice regulation. The primary purpose of a risk-sensitive premium structure is to provide an alternative to regulation as a means of controlling risks.

The remainder of this section examines alternative approaches to structuring risk-sensitive premiums. First, indicators of overall association riskiness (such as financial ratios) are discussed. Second, the approach of measuring individual types of risk is explored. Several approaches for measuring each of the major types of risk --interest rate risk, default risk, and management risk--are analyzed. The objective is to point out the pros and cons of alternative approaches rather than to design a recommended approach.

OVERALL RISK INDICATORS

Risk-sensitive premium structures may be scaled to a measure of overall institution risk. These overall risk measures include examination ratings, financial ratios, loan losses, earnings experience, and rates on uninsured deposits.

Examinations Ratings

Depository institutions receive ratings from their respective regulatory agency based on the periodic evaluation of the quality of their asset portfolios, asset-liability mix, compliance with regulations, internal management control systems, earnings, and capital. Each regulatory agency uses somewhat different examination techniques and categories, although the activities of the federal agencies are coordinated by the Federal Financial Institutions Examination Council (FFIEC). The FHLBB classifies insured member associations into four categories; use of these categories to scale the insurance premiums would be simple.

Several studies have shown that the examination ratings have not proved to be very accurate predictors of bankruptcy. They appear best at evaluating asset quality, management systems, and fraudulent practices, and weakest at evaluating interest rate risk, mainly because little effort has been directed toward measuring that risk. Much more important, however, is a significant conceptual problem with these ratings: nearly 900 examiners are involved in rating the 3,500 or so S&Ls. Because each rating is somewhat subjective, consistent ratings are difficult to produce. These ratings provide rough evaluations that are useful for supervisory reasons, but the precision of these evaluations does not appear to be sufficient for a risk-sensitive premium structure.

Financial Ratios

Several studies have reported close relationships between a limited number of important financial ratios for nonfinancial businesses and both their market-determined default risk premiums on their debt and their rates of bankruptcy. It would be theoretically feasible to relate failures to a number of financial variables and to estimate statistically the relative importance of each factor. Insurance premiums could be set for these statistical weights. Unfortunately, the empirical evidence for such relationships appears to be considerably weaker for depository institutions than for nonfinancial firms.

Regulatory agencies have attempted to construct early warning systems to provide advance notification of institutions that may encounter serious financial problems. These are based on a mix of examination reports and analysis of financial ratios.

There are two conceptual problems in the use of financial ratios. First, financial ratio models are primarily ad hoc statistical models designed to predict insolvencies rather than models intended to explain the nature and cost of risk exposure. Because no explicit conceptual relationship exists between the level of a financial ratio and the riskiness of the association, it is difficult to justify logically the use of variable-rate insurance premiums based on such ratios. For example, a high operating expense ratio may be a good predictor of financial difficulty, but there is no explicit justification for such a relationship. Second, financial ratios reflect both potential future problems and already incurred difficulties. To the extent that financial ratios reflect only already incurred problems, the effectiveness of the risk-sensitive premium structure in discouraging risk-taking is reduced because only unlucky risk-takers are penalized. To be effective, the decision to take risk should be penalized, not the unfortunate consequences of unlucky past decisions.

Past Loan and Security Losses

Because losses on loans and securities are a major potential cause of bank failures, insurance premiums may be scaled to past losses if they are viewed as reasonably accurate predictors of future losses incurred independently of past losses. A premium structure based on the experience of the insuree is common for most types of insurance. Drivers with records of traffic violations are charged higher premiums than drivers with better histories; home owners in high-crime areas are charged higher premiums than those in safer areas. These insurance premiums are based on the premise that traffic violations and aggregate crime statistics are reliable predictors of future problems. They serve as examples of using risk-sensitive premiums to discourage risk-taking and of spreading the cost of insurance more equitably according to benefits received.

Although not exactly the same as loan losses, the proportion of nonperforming, slow-paying, or scheduled loans appears to foretell future loan losses and thus may provide a measure of default risk. Whether those future losses are independently incurred difficulties or simply a continuation of previously incurred difficulties is unclear. To be effective in discouraging risk-taking, the risk measure used for assessing insurance premiums must be indicative of the level of risk in future loan decisions, not merely the level of risk in existing loans.

Past Levels and Volatility of Earnings

The lower are earnings, the slower is the growth in capital and the greater is the probability that a decline in earnings will need to be charged to capital. The more volatile are earnings, the greater is the probability of losses. Studies have found that these two variables--the level and the volatility of earnings--for nonfinancial firms are significantly correlated with market-determined default risk premiums and the incidence of default. If further research supports such relationships for S&Ls, insurance premiums could be scaled to them.

Interest Rate on Uninsured Deposits

Because uninsured depositors (those with balances in excess of $100,000) and other creditors of depository institutions are not protected by insurance, they must evaluate the financial strength of their institution as they would any investment. The riskier they perceive the institution, the higher will be the interest rate that they will demand on the deposits and other funds they lend to the institutions. Thus, rates on uninsured deposits and other funds incorporate a default risk premium just like rates on any other risky security. This premium may be viewed as the market's evaluation of the riskiness of the institution and thus could be used to scale the insurance premium.

This measure has three serious drawbacks, however. First, many S&Ls have minimal uninsured liabilities because they collect all the funds they need through deposits in amounts less than the $100,000 deposit insurance ceiling. Thus, a default risk premium cannot be observed for many institutions. Second, uninsured depositors, particularly at larger institutions, are routinely made whole in most instances by FSLIC assistance procedures if their S&L fails. Thus, partially uninsured depositors may not really expect losses and may not fully incorporate this remote possibility in the interest rates charged on deposits. To the extent that default risk premiums occur, they may be scaled to the expected response of the insurance agency in reimbursing creditors, as much as to the riskiness of the institution. Third, differences in large certificates of deposit and borrowing rates among individual institutions may reflect differences in marketability and location, as well as differences in default risks. Although some uninsured deposits are sold in national markets, the bulk of deposits over $100,000 are sold in local markets. It would be difficult, if not impossible, to develop an accurate system of risk measurement based on deposits issued in different local markets which are, to at least some extent, segmented from each other.

INDIVIDUAL RISK MEASURES

As an alternative to the overall risk indicators discussed above, risk-sensitive insurance premiums could be based on a combination of several individual risk measures. In the coming decade, savings and loan associations will likely be exposed to three major types of risk: interest rate, default, and management. The discussion below examines alternative means of measuring each of these risks.

Interest Rate Risk

Interest rate risk has received considerable attention in recent years as market interest rates both rose unexpectedly to record highs and became highly volatile. Depository institutions offer customers a wide variety of different types of deposits, the interest rates on which differ and change at different times in line with changes in market rates of interest on similar securities. At the same time, the institutions extend a wide variety of loans and purchase a wide variety of investment securities with different interest rates that change at different times. If the interest rates received on loans and investments do not change at the same time and in the same amount as the interest rates paid on deposits and borrowings, institutions bear the risk of incurring negative margins from unfavorable changes in market rates of interest. As has happened in recent years, interest payments could rise relative to interest revenues and the institution would incur losses. This is referred to as interest rate risk. Like most risks, interest rate risk is a two-edged sword. The institution may incur losses if interest rates change one way, but will achieve gains if rates change the other way. However, while the ability of an S&L to reap gains is open-ended, its ability to absorb losses and avoid bankruptcy is limited by its net worth position.

An institution assumes no interest rate risk over the life of the longest term asset or liability on its books if its interest revenues change at exactly the same time and by exactly the same amount as its interest payments. Changes in market rates of interest are then passed directly through from borrowers to depositors and conversely. The institution is effectively a conduit; it does not engage in maturity intermediation.

Measuring interest rate risk. One means of measuring interest rate risk is through the concept of duration. Duration may be viewed as a measure of the effective term to maturity. The relationship of duration to term to maturity is analogous to the relationship between an effective interest yield and a nominal interest rate. Both the duration and the effective yield give a present value weighting to interim cash flows prior to maturity. Duration incorporates not only the stated nominal term to maturity of the asset (or liability), but also its current market value, the coupon rate, the timing of coupon payments, and amortization payments. In the case of a pure discount instrument, such as a U.S. Treasury bill which has no coupon payments or amortization, duration is identical to maturity. In contrast, the duration (or effective term to maturity) of a mortgage loan is much shorter than its nominal term to maturity because of principal repayments and/or interest payments.

For an institution to avoid interest rate risk exposure, it should structure its balance sheet so that the average duration of its assets equals the average duration of its liabilities. This results from a basic property of duration, namely: duration measures the percentage change in the market value of an asset (or liability) resulting from a given percentage change in market yields (actually percentage change in 1 plus the market yield).

When the durations of an S&L's assets and liabilities of equal market value are not equal, fluctuations in interest rates will cause fluctuations in the market value of the institution. That is, fluctuations in asset values differ from fluctuations in liability values. The greater the mismatch, the greater the risk exposure. The difference between the durations of the two sides of the association's balance sheet indicates the degree of risk exposure. Moreover, this relationship is approximately linear so that a doubling of the mismatch or gap between the duration doubles the risk exposure.

For institutions such as S&Ls that use a historical cost accounting method rather than mark-to-market accounting, the connection between duration and the financial viability of the firm may not be immediately obvious. For S&Ls, the effects of changes in market interest rates on association net worth (on a book value basis) are distributed over time. The effect on revenues is spread over the life of assets; the effect on interest expense is spread over the life of liabilities. Thus, for associations, the impact on profitability and thus net worth is spread over a number of years. Duration simply summarizes those effects; the impact estimated by duration is simply the present value of those actual changes that are spread over a number of years.

This observation also suggests an important consideration in the use of duration measures. A given increase in interest rates may indicate that an association is insolvent on a market value basis. However, the use of historical cost accounting creates an important time dimension that affects the true risk exposure of savings and loan associations. Namely, because the adverse effects of increased market yields are spread over time, there is the chance that that increase in market yields will reverse itself before the association reaches insolvency on a book value (and hence legal) basis.

Interest rate risk really has two dimensions: cyclical rate fluctuations and upward ratchets in interest rates. The size of an institution's book value net worth and the use of historical cost accounting provide important protection against insolvency caused by cyclical rate fluctuations. The S&L has time to wait for rate increases to be reversed. This time dimension also affects permanent upward ratchets of interest rates. If such permanent upward shifts are not large, the S&L has time to adapt to those higher rates. If rate increases are too large, however, that period of reprieve will not be sufficient. Thus, if the record high interest rates of 1981-1982 had persisted, some S&Ls would have had sufficient time to adjust to the new high rates, while other S&Ls with smaller amounts of book net worth and greater maturity mismatches would not have been able to weather the transitional period.

Duration measures in conjunction with the market value of net worth can provide an accurate measure of the relative riskiness of S&Ls. The fact that duration is a market value concept may mean that it is a less precise measure of the riskiness of a firm on a historical cost accounting system. But it can accurately reflect the relative riskiness of associations, provided that due consideration is given to the fact that S&Ls actually use historical cost accounting rather than mark-to-market accounting. As a greatly simplified example, an S&L with a two-year duration gap between eight-year assets and six-year liabilities is safer than an association with a two-year duration gap between two-and-one-half-year assets and six-month liabilities. In both cases, net worth must be sufficient to weather a two-year gap to avoid insolvency in the event of an increase in market interest rates. However, in the former case, there is a longer period (six years versus six months) prior to the gap during which the rate increase may be reversed or the S&L may acquire additional assets at a positive spread--either of which could offset the original unfavorable effects of the increase in market yields.

Although duration is a relatively simple computation for an individual fixed coupon rate security, it is a more difficult computation for variable or floating coupon rate securities, and the process becomes highly complex for the very large number of different types of securities on the two sides of the bank balance sheet. It is also difficult, given existing technology and record maintenance systems, to project accurately interest revenues and expenses over the life of the assets and liabilities currently on the books of institutions. Not only must changes in flows from variable rate securities be predicted, but assumptions must be made about the turnover of maturing assets and liabilities, including deposits that do not have specific maturity dates (such as demand deposits, negotiable orders of withdrawal (NOW) accounts, and passbook savings) and about the interest rates on the replacement securities. Thus, simplified procedures must be used.

As is shown in Appendix A, it is possible to approximate the duration gap for securities traded in the cash market, that is, excluding futures contracts, by comparing the change in market values of a bank's assets and liabilities for a given change in interest rates. The greater the difference between the changes in market values of the two sides of the balance sheet, the greater is the risk exposure. Thus, it is simply necessary to take the market price of every item on the bank's books and subject it to an arbitrary interest rate shock. Savings and loan associations, however, do not typically maintain the market values of each of their assets and liabilities. They are generally recorded only at book value.

To convert from book value to market value, it is necessary to know the remaining term to maturity of the asset or liability, its contract interest rate, any provisions for changes in this contract rate before maturity, and the current market yield. Although S&Ls have a wide variety of different asset and liability items, they are grouped by like characteristics for reporting systems. Thus, it is possible to design a system that requires a reasonably smaller number of relatively homogeneous groupings of assets and liabilities by type, remaining term to maturity, fixed coupon or contract rate, and variable coupon rate characteristics.

A number of assumptions need to be made about the maturities of loans that are frequently prepaid or have variable contract rates and of deposits that do not have specific maturity dates. For example, it could be assumed that all residential mortgages with more than 12 years to maturity will be prepaid by the twelfth year, all savings and regular NOW accounts have a maturity of one year, and the new money market deposit accounts have a maturity of three months. (A more sophisticated scheme would specify the maturity of super NOW and money market deposit accounts equal to the time until the prevailing deposit rate may be changed, e.g., daily, one week, one month, etc.) The FSLIC could provide an interest rate value for each grouping based on representative current market rates of interest for securities in that group. For fixed-rate marketable securities, this would not be overly difficult. Interest yield data for many types of securities are readily available. For mortgages, it would require the construction of a yield series for fixed-rate mortgages with different terms to maturity. For nonmarketable securities, this presents a more difficult problem for the FSLIC.

For variable-rate securities, the problems are more complex. The most difficult task is to estimate meaningful market yields for deposits subject to rate ceilings and associated with free services such as check writing. But these are decreasing in importance as deposit rate deregulation proceeds. The optimal system would involve the projection of cash flows on both sides of the balance sheet based on the individual institution's management best estimates of the timing and magnitude of the repricing of variable-rate loans and deposits, prepayment of loans, turnover of deposits, and so on. These projections would be updated each time it was necessary to measure risk exposure.

Using the simplifying assumptions above, it is possible to compute changes in the aggregate market value of the securities in each asset and liability group for a given change in interest yields. This is done through the use of a typical bond pricing equation that relates the change in market price to the maturity of the securities in the particular group and the change in interest rates.

Some asset and liability items, however, cannot be valued by a bond pricing equation because they are not interest-bearing. These items include buildings, equipment, assets obtained through foreclosure, and so forth. Yet, if a market value determination is to be made for interest-bearing assets and liabilities, a market value determination should be made of these noninterest-bearing fixed assets to assure that the risk measurement system is as accurate as possible. If such an adjustment were not made, the system would be biased against S&Ls that hold relatively large amounts of noninterest-bearing assets.

Another complication of duration measurement is that as time passes and/or interest rates change, the market values and thus the durations of the assets and liabilities change. Thus, a risk measure is valid only for a particular moment in time. In theory, even if the S&L does not deliberately change its risk exposure, its risk measure should be computed continuously so as to prevent the value of the insurance premium from deviating very far from the current risk exposure of the institution. If this occurred, the risk would be mispriced, presenting the S&L with incentives to change its risk exposure further to take advantage of the mispricing. In practice, because of high reporting costs, it would be difficult to justify computing a savings and loan association's risk exposure and altering its insurance premium more than once or, at best, twice a year. Thus, it would be reasonable to develop an ongoing monitoring system that would identify evidence of dramatic changes in the association's risk exposure sufficient to warrant recomputing the risk more precisely and repricing the premium.

In recent years, S&Ls have been given permission to hedge their operations in the futures market. To the extent that they have done so, this action should reduce their exposure by reducing the size of their asset-liability duration mismatch. Gains and losses from futures hedges that are properly designed act to offset the net change in the value of cash market assets and liabilities. Thus the earlier procedure of computing the change in the value of assets and liabilities should be adjusted by adding futures gains (or losses).

One additional adjustment is necessary. Because deposit insurance does not require payouts until net worth is at least zero, S&Ls with equal interest rate exposures would not necessarily be equally risky to the insurance agency if they had different amounts of net worth. Associations with relatively larger net worths would be less risky than those with smaller net worths. In effect, net worth is analogous to a deductibility clause in regular insurance policies. The insurer pays only if the loss exceeds the amount of the deductible. Insurance firms generally permit the insuree to determine the amount of the deductibility it wishes to assume, and to scale the insurance premiums accordingly. The larger the deductibility, the smaller the premium charged. Thus, it appears reasonable for the deposit insurance agency to permit S&Ls a deduction or other adjustment for the market value of their net worth relative to assets before determining their premium.

The foregoing discussion delineated the conceptual concerns in devising a method of measuring interest rate risk. However, given these conceptual concerns, there are alternative methods of implementing this procedure, including a mark-to-market (or duration gap) approach and a maturity gap analysis approach. Advantages and disadvantages are associated with each.

Mark-to-market (duration gap) approach. The previous discussion was couched primarily in terms of a mark-to-market (or duration gap) approach; that is, the interest rate risk exposure was quantified by comparing the mark-to-market adjustment for assets to that of liabilities. To make such a measurement, the coupon rate, remaining maturity, and type of asset or liability must be known, as well as the current market yield for such an asset or liability. To implement this approach, S&Ls would have to alter their internal record-keeping. Associations would have to keep balance sheets by term to maturity of each asset or liability category. The FSLIC would have to make periodic estimates of the market yield for each asset or liability category.

The mark-to-market approach would thus require significant changes in S&L reporting and FSLIC administrative procedures. The accuracy of such a system is potentially very high; however, that accuracy would depend on how accurately the FSLIC estimates market yields for the different asset or liability categories. It should be stressed again, however, that perfectly accurate measurement of the risk is not necessary for a useful risk-sensitive insurance premium structure. What is important is that the system measure risk more accurately than the current system, which implicitly assumes that all S&Ls are of equal riskiness.

Maturity gap analysis approach. An alternative approach is to group assets and liabilities by maturity categories and to adjust premiums accordingly. For example, maturity categories could be set at less than one year, one to five years, and over five years. Savings and loan associations would allocate assets and liabilities to the three categories and determine the net maturity imbalance. This net imbalance would be used instead of the duration gap to determine the relative risk exposure of S&Ls. This approach would be similar to the so-called gap analysis that many institutions construct in designing futures hedges.

The advantages of the maturity gap analysis approach are that it is simpler and more widely understood than a duration gap approach. Some S&Ls already construct maturity gap analyses, but few use the duration concept itself. The disadvantage of maturity gap analysis is that it is a less perfect measure of interest rate risk than duration gap, particularly as if the maturity categories are not well defined.

Default Risk

The more traditional risk incurred by depository institutions has been losses on their loans and investments from default. To compensate for such expected losses, institutions, similar to all investors, demand higher interest yields on loans and investments subject to default risk than on securities not subject to default.

The higher yield serves to compensate the lender for the greater likelihood of loss. Thus, the difference in yields between a security with default risk and a comparable security without this risk may be viewed as an insurance premium paid by the lender to itself, or a self-insurance premium. That premium could serve as a basis for evaluating the default risk exposure of S&Ls. Alternatively, the FSLIC could base insurance premiums on the historical loss experience of different asset categories.

Market-determined risk premiums. The difference between the market yield on a security subject to default loss and a comparable default-free security is referred to as the "default risk premium." For marketable securities, the premium is determined by the market. This premium reflects the weighted average of the default expectations on a particular security by individual market participants. That premium reflects expected losses, "worst case losses," and the reward that must be paid to the investor to assume the risk of loss. Of course all individual investors may not be expected to evaluate the risk of a particular security equally. Additionally, expectations may not be realized, and actual default losses may be greater or smaller than the expected loss impounded in the default risk premiums.

There have been only a few studies that tested empirically the efficiency of the market-determined default risk premiums. These studies have related market default risk premiums to the actual default losses experienced by investors by tracing groups of corporate and municipal bonds through their lives. Two findings are: First, the timing of defaults is not uniform but varies with the business cycle. They are lowest during periods of economic prosperity, higher during recessions, and much higher during major economic depressions. Second, over sufficiently long periods of time, differences between the yields realized on the securities and the yields promised at the time the securities were purchased approximated the default risk premiums. On the whole, these studies indicate that market-determined default risk premiums are accurate estimates of risk exposure.

Most of the assets held by thrift institutions, however, are not marketable securities. Thus, there is not a market-determined risk premium for each asset in the institutions' portfolios. Determining risk premiums for such assets would involve the difficult task of finding comparable market-traded risk-free securities. To complicate matters, thrift institutions are offering an increasing variety of loans, including variable-rate and graduated-payment residential mortgages, for which market default experience is very limited. Furthermore, the inclusion of prepayment (call) and due-on-sale (put) options makes it difficult to separate out default risk premiums. Unlike most securities broadly traded on the markets, mortgages are amortized securities whose terms to maturity are far less representative of their average lives than these terms are for regular coupon securities. In sum, it will be difficult to find comparable default-free, broadly traded securities from which market-determined default risk premiums may be computed.

Historical loan losses. Given the difficulties of estimating market-determined risk premiums on S&L assets, an alternative approach to measuring credit risk that may merit consideration is to assess risk according to the historical loss experience for each type of asset. Indeed, market-determined risk premiums are merely the result of investor assessment of the risk resulting from such historical experience. There are a variety of possible sources of information on the incidence of default and the magnitude of losses resulting from those faults. Insurance premiums could be made variable according to loss experience for each category of assets.

There are, however, difficult problems involved in taking this approach. Market-determined risk premiums reflect several complicated subjective judgments about default losses on assets. Since it is clear that market-determined premiums are the theoretically correct base for assessing risk-sensitive insurance premiums, the indirect (but perhaps more practical) approach of using loan loss data requires that the FSLIC make the same subjective judgments about those default losses that market investors would make. More specifically, information must be obtained on expected (or average) losses, worst (and best) case losses, and the price of risk (the reward investors must be paid to bear risk). Additionally, the effects of asset diversification on risk exposure must be evaluated. It is obvious that these complications are formidable.

The overall complication of this approach is to set a "price" for this risk of loss. Should the incremental premium be set equal to the average loss experience for an asset category or should those incremental premiums be set above or below such expected losses? Should the distribution of possible losses (worst case versus best case) around the expected level be considered? Another complication is whether national averages should be used, or should risk assessments take into consideration regional differences, individual association differences, differences of risk over the business cycle, and so forth. Using the loss experience approach offers the advantage of being able to choose among such factors, whereas the market risk premium approach offers no such flexibility. On the other hand, it is clear that the closer that insurance premiums reflect market-determined risk premiums, the more "economically optimal" will be the result in the sense that the FSLIC system will best reflect societal attitudes toward risk-taking.

Diversification. Whether a market-determined approach or a historical loss approach is used, diversification presents a significant problem. Savings and loan associations can significantly reduce the likelihood of experiencing a large number of loan losses in any one period of diversifying their asset portfolios across borrowers whose income flows are not perfectly positively correlated. The lower the correlation coefficient (ranging from +1.0 for perfect positive correlation to -1.0 for perfect negative correlation) for losses among different assets, the lower will be the overall risk of the association relative to the riskiness of each individual asset category. Thus, measuring the riskiness of individual assets is insufficient for assessing overall S&L riskiness; the correlation of losses among assets, reflecting how well the association is diversified, must also be measured. Although the average risk measurement of individual assets (considered separately) of two associations may be similar, there may be marked differences in their overall riskiness due to diversification differences.

Considerable research has been devoted to the effects of diversification on risk and how organized financial markets reflect diversification in market-determined risk premiums. However, as discussed above, the bulk of S&L assets are not traded in active organized markets and thus the applicability and usefulness of that research is limited for present purposes. Important differences include geographical location of borrowers, noneconomic behavior of some consumers in some instances, and borrower-lender size effects. Widely accepted financial principles as to the effects of diversification must be carefully reconsidered before being applied to depository institutions.

Although it is clear that an accurate assessment of diversification is absolutely necessary for an accurate measurement of overall default risk, it is equally obvious that measurement problems are formidable. It would appear feasible to measure some diversification effects on a nationwide scale. However, if geographical dispersion is important, it would be a virtually impossible task to consider every local market in the United States when measuring diversification. Diversification represents the greatest obstacle to measuring default risk. However, as stressed throughout this report, a perfect measurement system is not necessary for risk-sensitive premiums to be useful.

Management Risk

The third major category of risk that may be useful to distinguish in evaluating S&L riskiness in future years is that of management risk. For purposes of this study, management risk refers to the risk of exceptional, spectacular failures resulting from management misuse of new asset and liability powers. For the most part, this risk is really the same thing as interest rate risk or default risk. However, it may be useful to differentiate between moderate degrees of such risks and the extreme exposure that results in isolated cases.

For example, during the late 1970s a few S&Ls engaged in excessive activity in the Government National Mortgage Association forward market. In one particular case, an S&L failed because of its inability to fund forward commitments which exceeded the total assets of the association. While such an exposure was simply interest rate risk, it was a special situation that perhaps should be labeled management risk.

In the coming years, more instances of similar spectacular excesses and failures may occur. Associations have gained tremendously broadened powers, such as adjustable mortgage loans, futures hedging, debt options hedging and investment, outside borrowing, brokered deposits, commercial loans, and so forth. Not one of these new powers in itself represents an excessively risky undertaking, provided that activity is properly planned and implemented. The risk exists, however, that an inexperienced management may get involved in an operation that requires far more expertise and sophistication than that management can provide. The result would be an isolated, spectacular failure with huge losses to the FSLIC.

Although it is instructive to single out and consider management risk, it is almost impossible to detect and measure and it is perhaps counter to the spirit of deregulation to deal with it. Suppose the FSLIC did detect an S&L whose managers, examiners believed, were incapable of handling a new activity. If that management risk were accurately priced through a variable-rate insurance premium, that association would be precluded from that new activity. The major problem with this situation is that it calls for the examiner to make a subjective judgment of the expertise and sophistication of the S&L's management. This situation has two serious weaknesses: the necessarily subjective nature of such examiner judgments, and the need for examiners to acquire a high level of expertise in these many new areas.

Thus, it appears that management risk is an interesting theoretical concept but is essentially impossible to quantify and incorporate into a risk-sensitive insurance premium. Two notes are in order. First, failure to measure management risk does not invalidate the use of a risk-sensitive insurance premium. Such a premium structure would simply be less than perfect. Second, it appears unlikely that large numbers of S&Ls would incur significant management risk exposure for the FSLIC. The vast majority of S&Ls will probably be very conservative in exploiting new powers and as such management risk will not likely be a major source of risk for the FSLIC.

SUMMARY

Accelerating trends toward the deregulation of depository institutions, innovations in financial services, and increased competition in financial markets have made the current structure of flat-rate deposit insurance premiums increasingly inappropriate. Risk-sensitive deposit insurance premiums provide an alternative to regulation as a means of controlling the risk-taking behavior of associations. Additionally, risk-sensitive insurance premiums more equitably distribute the costs of insurance among S&Ls by charging higher premiums to riskier associations.

The major categories of risk for S&Ls are interest rate risk, default risk, and management risk. Ideally, a risk-sensitive insurance premium structure would perfectly measure all of these risks and would charge a commensurate premium. However, such accuracy is not absolutely essential. Risk-sensitive insurance premiums can be useful and effective as long as the elements of risk that are measured are clearly related to failure, the measurement system provides a more accurate risk assessment than the present flat-rate scheme, and the premium structure does not create perverse incentives for institutions to assume other risks that are not used as a basis for premiums.

SECTION V

EXPANDING PRIVATE INSURANCE

(460)

The United States has had federal insurance of deposits at savings and loan associations (S&Ls) for nearly half a century. The Federal Savings and Loan Insurance Corporation (FSLIC) and the Federal Home Loan Bank Board (FHLBB) have been extremely successful in fulfilling the original Congressional goal of providing a continuous source of housing finance and have had unparalleled success in protecting depositors. The combination of premium assessments and income from investments has provided net income to the fund in every year since the FSLIC was established. Over the same period, the FSLIC resolved 248 S&L failures at the cost of approximately $4.6 billion.

In the past two years, however, the problems facing the FSLIC have been more serious than at any other time. Assistance costs in 1981 and 1982 alone nearly equalled the cumulative cost of assistance in the previous 45 years; and despite the recent decline in interest rates, the FSLIC will probably be confronted with more failures in 1983 than in the past two years. In addition, the costs incurred by the FSLIC are likely to increase as it begins to issue the net worth certificates legislated in the Garn-St Germain Depository Institutions Act of 1982. Even if interest rates remain at current levels, it is expected that by 1985 the FSLIC will issue $2 billion in net worth certificates, while only $100 million will be repaid.

The past success of the FSLIC has been a result of regulations that ensured that member institutions did not subject the FSLIC to excessive risk. However, the legislative actions in 1980 and 1982 to deregulate financial intermediaries will limit the ability of federal regulators to control risk as directly as in the past. One alternative for controlling risk exposure in this new environment is to transfer all or part of the deposit insurance system to the commercial insurance industry, which might exert a risk prevention influence through premium pricing and other forms of competitive pressure.

Indeed, as a matter of principle, the government should act as an insurer of private depository institutions only if such insurance offers a clear public benefit that cannot be provided in the private sector. However, as long as the government provides deposit insurance with uniform and relatively low premiums based solely on deposit volume, not only will the FSLIC's operating results continue to deteriorate, but also it will be impractical for private insurers to enter the field. On the other hand, if the federal deposit insurance agencies seek to improve their deteriorating financial performance by pricing and managing their insurance on conventional underwriting principles, it is appropriate to consider whether transferring all or part of the deposit insurance to the private market would be more advantageous.

Three important benefits could result from private rather than public deposit insurance. First, private regulation would be substituted for public regulation to some extent. Although federal regulation probably would remain the primary source of institutional scrutiny and information, private insurers could be expected to use this body of information, as well as their own independent examinations, to develop insurability standards and pricing differentials that would create direct economic incentives for financial institutions to comply with certain standards of prudence. Second, deposit insurance presumably would be priced by the market to eliminate the subsidies or adverse incentives for risk-taking inherent to the present pricing system. Third, greater economic efficiency presumably would be achieved, and a drain on federal assets in all but the most severe financial crises might be forestalled.

Underlying these benefits is the assumption that, unless there is a clear and compelling reason to believe that the market cannot operate effectively, market-oriented pricing and management are inherently superior to government regulation. However, although it seems clear that private insurers could play [illegible] role in deposit insurance, it is doubtful that a completely private deposit insurance system could be formed. Some ultimate federal guarantee may be essential for public confidence. Moreover, sufficient capacity may not exist in the private market to cover the losses that would accompany a banking panic, severe monetary inflation, or other macroeconomic failure. In any event, the total loss exposure of any private insurer necessarily must be finite and well defined; without a federal "backstop," this limitation would seem inconsistent with the confidence function of deposit insurance.

Inherent to any joint private-governmental insurance scheme is the need for a cooperative relationship between regulators and private insurers during financial crises. It would also be necessary to define in advance the types of risks covered by each, as well as the relative rights and powers of the regulators and insurers to enforce capital requirements, extend liquidity, require merger of institutions, and the like.

Although a joint private-public system might be structured in a number of alternative ways, the benefits often attributed to a private insurance program presuppose that the private sector will have substantial authority for underwriting, pricing, and enforcing insurance contracts related to its share of the market. The transfer of such responsibilities may prove to be the most difficult aspect of devising a joint public-private deposit insurance program.

It also should be recognized that private insurance probably would be available only to a financial industry that insurers perceive to be basically healthy. Furthermore, a private insurance scheme, which would essentially redistribute risk within the insured industry, would only provide a level of confidence by which the industry might attract capital. Such private insurance would not itself contribute any new capital to the industry, a role that only the federal lender-of-last-resort could fill.

This section discusses the limitations on a completely private deposit insurance system and evaluates alternative ways to structure a joint public-private deposit insurance system for depository institutions. As a first step, however, a review is made of the basic principles of private insurance markets that cover diverse risks and are characterized by considerable flexibility and innovation. Briefly examined are some of those markets that are similar to deposit insurance or have characteristics of particular relevance to the problem at hand--casualty insurance, especially catastrophic loss insurance, and various types of financial guarantees.

THE PRINCIPLES OF PRIVATE INSURANCE

Private insurance markets exist to transfer or redistribute risks and thereby reduce individual uncertainty. One way of coping with the risk that one's loss experience will be disproportionately great in relation to the loss experience of similar persons, is to treat as a unit the combined risks of a large number of persons or ventures of a given type. That is the essence of insurance. As the number of ventures in the group under consideration is increased, protection is improved against the chance that the severity and number of harmful events will be spread over time or in other ways disproportionate to the overall risk. As the numbers in a combined pool increase, the unusually favorable and unusually harmful experiences tend to stay more nearly in balance, just as the percentages of heads and tails in the flip of a coin tend to balance as the number of tosses increases.

The prediction of harm to a single enterprise is largely a guess, even if based on good information. But if the number of players is large and the information on past experience of similar enterprises is sufficient, the prediction of total group losses can be quite reliable, and the total cost of bearing the risks can be reliably calculated.

Effective pricing of insurance requires an actuarial basis for estimating the chance that the insured event and the resulting loss will occur. In many types of insurance the loss is readily defined ex ante; for example, in life insurance it is set contractually. When there is little actuarial basis for estimating the risk, it is more difficult to price insurance efficiently. Considerable historical information exists from which to derive estimates of the risk of insolvency of deposit institutions. Even if one assumes that recent deregulation alters the odds, the experience of unregulated financial firms and unrelated enterprises of comparable size, quality of management, etc., presumably provides a basis for adjusting the historical pattern for depository institutions.

Each policyholder can be charged as premium an amount equal to a proportionate part of the total predicted cost of meeting specified types of losses in a number of similar ventures, plus a sum for administrative costs. The insurer, collecting premiums from many policyholders, increases the number of parties in the risk pool to the point that this principle of risk distribution operates satisfactorily. If an insurer cannot attract or cover a large enough pool to reach this point, some risks may be transferred by turning to another insurer for reinsurance.

Reinsurance, as the term suggests, involves the assumption by one insurer of all or part of the risk originally undertaken by another insurer. Reinsurance permits the direct insurer to protect against accumulation of losses arising out of catastrophes, to provide greater capacity to accept risks than otherwise, to stabilize operating results, and (particularly for smaller insurers) to be more competitive in the market place. For the same reasons, reinsurers may at times reinsure their own risks. This practice is known as retrocession. Reinsurance may be either pro rata, where the reinsurer and the insurer share proportionately in the premiums and losses, or excess, where only the losses of the direct insurer above a fixed retention point are reinsured.

This risk-distribution principle in turn depends on two assumptions which, if not present, would undermine the feasibility of the insurance scheme. First, the individual risks must be sufficiently diverse, that is, independent of one another, so that the exposures are not too concentrated or cumulative. Obviously, in the case of deposit insurance, the risks of institution failures during a financial panic or other macroeconomic crisis would be linked, and private deposit insurance might have to be tailored to exclude some or all coverage for failures owing to defined general events, with that excluded coverage to be provided by public institutions.

Second, the insurance and premiums must be designed to avoid adverse selection. Whenever a large group of potential insureds are treated alike, irrespective of factors that differentiate them as insurance risks, a disproportionately high percentage of applications for such coverage will tend to come from the less desirable applicants because they get the better bargain. Presumably, however, adverse selection can be avoided, or adequately taken into account, in a private deposit insurance scheme by devising a system to classify the riskiness of institutions (and thus to structure premiums) based on asset choice, quality of operations, size of institution (presumably a factor in probability of failure), use of outside auditors, and the like.

A number of additional difficulties are involved in devising an efficient insurance market. For example, insurance against catastrophic loss often involves special limits on the insurer's loss exposure. Moreover, the insured party must also assess the potential for insolvency of the insurer. If the potential catastrophe is large enough, the risk may be uninsurable or, more accurately, only partially insurable. Also, to some extent moral hazard--the incentive of the insured party to cause an insured loss--is inherent to all insurance contracts. For example, a fire insurance contract contains moral hazard if the coverage is so extensive that the homeowner has no incentive to undertake simple fire prevention procedures. Insurance contracts must use exclusion terms, deductibles, and pricing structures to maintain incentives for the insured to prevent loss.

CASUALTY INSURANCE

Casualty insurance is one of the four broad classes into which insurance is commonly grouped based on the nature of the risks covered; the other three major classes are life, property and fire, and marine insurance. Casualty insurance includes liability, workers' compensation, accident and health, burglary and theft, property damage and credit insurance, and fidelity and surety bonds (Keeton 1971, 11-18). Generally, forms of casualty insurance most closely compare with deposit insurance. A description of existing casualty insurance products that possess features relevant to the deposit insurance problem follows.

Insurance of Catastrophic Loss

Risks arising from some catastrophic events, such as hurricanes, typhoons, or earthquakes, present insurers with special problems because the exposure of many of the insured parties will be affected by the same event, allowing little diversity of risk. Moreover, the threat of such hazards tends to be concentrated in limited geographic areas, and adverse selection occurs. Consequently, the availability of affordable insurance against some such risks may be limited. On occasions, the federal government has supplemented the private market with an insurance program (e.g., flood insurance) or a system of disaster relief when natural disasters devastate a region beyond the level of coverage provided by the private market. In principle, a parallel exists between this government role and its role as an insurer of deposits because in both cases the federal government might be needed to fill a gap related to truly catastrophic events.

Nevertheless, private insurers have demonstrated versatility in insuring many such extraordinary hazards. When catastrophic insurance is provided in the private market, it is generally in cases where the incidence of loss is low enough that the public is willing to pay a premium that allows the insurer to break even. For example, private earthquake insurance is now available to California home owners' insurance policyholders for an additional premium. The fact that most Californians do not purchase such earthquake insurance makes it easier for insurers to avoid concentration of risk. Nevertheless, today commercial insurance, such as business interruption coverage, does exist and is being purchased on an all-risk basis that includes earthquake coverage.

In other instances, insurance companies have found it necessary to develop a specialized set of procedures to limit and redistribute risk. Among these practices are syndicated underwriting through insurance pools, setting maximum loss limits on coverage, reinsurance of major exposures in the reinsurance markets, and especially the channeling of the exposure along a well-defined reinsurance path so that the reinsurers bearing the ultimate loss know in advance the full extent of their exposure for any one event. An enlightening example of how catastrophic loss insurance is structured is the market for insurance against accidents in nuclear power plants.

Nuclear Insurance

Nuclear peril protection for electric utilities is currently provided by two large commercial underwriting syndicates, or pools, that have evolved since 1957 to write property and liability coverage for U.S. nuclear reactors, as well as by two recently developed utility mutual insurance facilities offering more limited coverage. One pool--American Nuclear Insurers (ANI)--is composed of 146 American stock insurance firms. Its mutual association counterpart--the Mutual Atomic Energy Reinsurance Pool (MAERP)--is a joint underwriting association of about 120 American mutual insurance companies. Participation in nuclear underwriting through pools allows each pool member to offer only a pro rata portion of insurance in force, thereby dispersing the risk of an adverse event.

Together, the nuclear underwriting pools currently provide primary property capacity for nuclear power generators approaching $500 million and approximately $100 million of pro rata coverage on $500 million of property damage in excess of $500 million. More than 50 percent of this combined primary and excess property capacity (about $300 million) is currently supplied by foreign reinsurers in world markets, including syndicates at Lloyd's in London, 17 foreign nuclear pools, and individual reinsurers. In addition to property capacity, the U.S. pools currently write $160 million of primary nuclear liability insurance and a $30 million aggregate contingency liability cover. Major portions of these coverages are also reinsured in world markets.

The other principal sources of nuclear reactor insurance are the two mutual insurance companies created by the insured utilities: Nuclear Mutual Limited (NML) and Nuclear Electric Insurance Limited (NEIL). NML provides primary and excess property insurance of $500 million. NEIL offers excess property insurance and a second product, called extra expense insurance, which covers part of the cost of purchasing replacement power when a reactor has suffered outage from a period covered by the primary insurance. Total primary and excess nuclear property coverage available for any one reactor through combinations of ANI/MAERP, NML, and NEIL policies now approaches $1 billion. (See, e.g., 47 Fed. Reg. 27371-73 (June 24, 1982).)

Both the ANI/MAERP and NML primary coverage are all-risk insurance; it applies to any peril not explicitly excluded, and as a result covers conventional perils as well as radioactive contamination. This tends to balance the risks to which the insurers are exposed and to make the coverage more affordable.

A major difference should be pointed out between ANI/MAERP insurance and NML and NEIL coverage. ANI/MAERP insurance is financed by fixed premiums (i.e., it is guaranteed cost insurance, but subject to a lower future rate if loss experience is favorable). By contrast, NML and NEIL insurance depends not only on annual premiums, but also on assessments, termed "retrospective premium adjustments," which NML or NEIL can call for from the utilities if and as needed to pay losses incurred. This allows NML or NEIL to charge a lower premium initially.

It is conceivable that financial institutions could form mutual insurance facilities, either with full premiums to provide ex ante funding, or with retrospective premium assessment devices like NML and NEIL. It should be recognized that the latter type of coverage may be riskier, particularly in the financial institution context, where successive failures could adversely affect the remaining institutions expected to pay the assessments. Moreover, without full premiums payable in advance, it would be more difficult, if not impossible, to establish the reinsurance networks needed to assemble large amounts of capacity.

Through the reinsurance mechanism, the pools effectively aggregate the available worldwide capacity for nuclear peril protection and greatly magnify the amount of coverage the pools could otherwise provide for a given number of insured units. In fact, the total of the property and liability coverages cited above constitutes the worldwide maximum, single-occurrence capacity currently available from private insurers. Nevertheless, these coverage ceilings are substantially lower than published estimates of the amount of losses that could be sustained in the event of a major nuclear accident. These coverage limits, which increase as additional insurance capacity is developed, exist to protect insurers who simply do not possess sufficient capacity to assume the estimated losses associated with potential nuclear perils.

The nuclear insurers have been able to assemble large capacity because, through intricate nuclear exclusion clauses used by all the pool members in their other types of insurance (e.g., home owners) and related reinsurance treaties, they have been able to give their reinsurers more or less absolute assurance that the only liability the reinsurer will face with respect to any one nuclear accident has all been channeled exclusively through the pool.

FINANCIAL GUARANTEES

The segment of the private insurance industry that is probably most closely related to deposit insurance is the financial guarantee industry. Actually, there is no well-defined market for financial guarantees or a financial guarantee industry; instead, there are a number of distinct products that involve a guarantee by a third party on some kind of financial instrument. At least four major types of financial guarantees are used in the current financial markets: letters of credit, surety bonds, mortgage insurance, and insurance on marketable bonds, particularly municipal bonds.

Letters of Credit

Letters of credit are probably the oldest form of financial guarantee widely used in the United States. A letter of credit is a commitment, generally made by a commercial bank, to honor the financial obligation in a debt agreement if the borrower is unable to do so. Letters of credit are similar to bankers' acceptances, developed as a device for providing security in international transactions. The bank that issues a letter of credit substitutes its own creditworthiness for that of the borrower in a debt agreement. The borrower pays the bank a fee for the letter of credit that depends on his own credit reputation with the bank and the maturity of the financial obligation. Letters of credit cover a wide variety of financial obligations with different terms and maturities, but they do not constitute a separate insurance market. Instead, they are intimately tied to the general lending activities of commercial banking.

Surety Bonds

Surety bonds are instruments that, in exchange for a premium, guarantee to one party that another will perform specified acts, usually within a specified period. Bid bonds and performance bonds, for example, promise that a construction contract will be performed and that all suppliers will be paid.

An example of joint public-private bonding is the special bonding program developed by the Small Business Administration (SBA) to aid minority-owned contracting firms. Under the Surety Guaranty Program, the SBA agrees to indemnify participating surety companies for 90 percent of their loss costs and expenses incurred on any bid, performance, or payment bonds underwritten for small business concerns acceptable to the SBA and the surety company. The surety company in turn pays the SBA 20 percent of its premium for the guarantee.

Fidelity bonding, a form of suretyship, is a means of protection for employers against financial losses due to theft, embezzlement, and other dishonest or fraudulent acts by employees. Financial institutions are among the leading purchasers of fidelity bonds, along with political subdivisions and other kinds of employers who entrust to certain employees the responsibility for handling funds, securities, and other assets.

Mortgage Insurance

Perhaps the insurance product that is most similar to deposit insurance--particularly deposit insurance for S&Ls--is mortgage insurance, which insures against default on mortgage debt obligations. This insurance is provided by firms that constitute a distinct mortgage insurance industry. The contemporary mortgage insurance industry began operation in the United States in 1957 with the founding of the Mortgage Guarantee Insurance Corporation. (An earlier U.S. mortgage insurance industry became insolvent in the Great Depression.) In 1982 mortgage insurance companies had insurance outstanding on approximately $140 billion in mortgages.

The Federal Housing Administration (FHA), an agency of the U.S. Department of Housing and Urban Development, has for years provided mortgage insurance. Recently, because of the applications backlog occasioned by the decline in interest rates, a bill (S. 835) has been introduced in Congress that would authorize FHA, through reinsurance agreements, to take advantage of the "operational ability and financial capacity" of the private mortgage insurance industry to help relieve FHA's backlog (Congressional Record, March 17, 1983, S.3284).

The most obvious similarity between mortgage insurance and deposit insurance is that the underlying assets of S&Ls are largely mortgages. Therefore, to some extent mortgage insurance already represents a joint public-private insurance system for deposits in these institutions. Moreover, this insurance is required by regulation for mortgages that have debt financing in excess of 80 percent of the value of the property at the time of sale. Hence, the regulators have used their existing authority to arrange private participation in the insurance process.

To avoid the problems that led to the demise of the pre-Depression mortgage insurance industry, a new mortgage insurance product that would have a greater chance of surviving a period of severe financial distress was designed. A number of important features distinguish this product, of which the most important are probably co-insurance in the mortgage insurance contract and the long-term nature of that contract. In this case, the co-insurance is between the insured party and the insurer, who are jointly at risk if the mortgage ends in default. Co-insurance is incorporated in mortgage insurance contracts by stipulating that the insurer is responsible for losses only up to a fixed percentage of the outstanding balance of the loan on the property; the lender is exposed to loss of the remaining percentage of the loan balance. As a result, the lender has an incentive to process the foreclosure promptly and to manage the sale of foreclosed property efficiently.

Although co-insurance is an important part of mortgage insurance, the key to the success of mortgage insurance is the long-term nature of the contract. Mortgage insurers do not maintain the right to cancel an insurance contract; rather, the contract is renewable at the choice of the insured, subject to the regulatory requirement that mortgages that represent more than 80 percent of the value of the property must be insured. The premium structure involves both an initial premium and a renewal premium.

This kind of insurance contract is distinctly different from the traditional type of contract used in casualty insurance. In a casualty insurance market, those who do not file a claim during a given year pay premiums that are used to cover the losses incurred by those who do file a claim during that year. If losses increase from one year to the next, premiums may be raised to cover increased expected losses. Generally no long-term contract is available and therefore there is no intertemporal transfer of premium income. In mortgage insurance, premiums are collected during years when aggregate losses are very low for use in years when mortgage default rates increase.

The intertemporal transfer of premium income is essential in this market. The reason for this feature of mortgage insurance is an intertemporal adverse selection problem. If mortgage insurance contracts were not long-term commitments, lending institutions and borrowers would want to be insured only in times when they expected high-default incidence. Perhaps more importantly, insurers would want to cancel in times when high-default incidence could be expected. By combining regulatory restrictions that require mortgage insurance on loans that are sufficiently leveraged and long-term commitments from the mortgage insurers, the adverse selection problem has been largely overcome.

The type of adverse selection found in mortgage insurance is also likely to be an important part of any private market in deposit insurance. In financial guarantees of this kind, there is almost always an intertemporal as well as a cross-sectional transfer of premium income. Hence, any deposit insurance system would probably not be able to operate effectively if insurers could cancel insurance coverage in all cases. Yet the right to cancel under certain circumstances is often used to control risk in insurance contracts, and it is not clear that private insurers could insure deposits without such a cancellation feature. Similarly, there probably would have to be some mechanism for binding those who purchase the insurance to a long-term contract without termination rights. Whether this is feasible remains to be seen.

Bond Insurance

A new type of financial guarantee market, in many respects like mortgage insurance, emerged in the United States during the 1970s. The insured instruments are, in theory, any marketable debt security of investment grade. However, at the present this market has been restricted largely to the obligations of state and local governments or municipal bonds.

Recently, several insurance brokers have attempted to create special hazard coverage to guarantee a variety of other investment securities for lenders, and thereby lower the capital costs to the issuers of the securities. To date, the market acceptance of the program appears to have been limited (Bergson 1982, 55-56). Perhaps more interesting, at least one major money market mutual fund has obtained insurance for its depositors from a major property/casualty insurer. This insurance would appear to be a close parallel to deposit insurance, presenting similar risks of management failure or macroeconomic hazard.

Municipal bond insurance is written principally by the American Municipal Bond Insurance Corporation (AMBIC), a subsidiary of the federally chartered Mortgage Guarantee Insurance Corporation, and by the Municipal Bond Insurance Association, which is owned and operated by a consortium of five major casualty insurance companies. This type of financial guarantee is similar to mortgage insurance in that it backs up a debt instrument, incorporates co-insurance principles, and involves a long-term contract; however, its value to the party purchasing the insurance is quite different. The municipality that purchases the insurance benefits from an improvement in rating on its debt obligations. In effect, the borrower who purchases a guarantee on its municipal bonds has purchased access to the rating of the guarantor. If that rating is higher than the rating of the issuer, this can lead to a reduction in the cost of issuing the bond, just as deposit insurance presumably reduces the borrowing costs to an S&L.

A parallel with deposit insurance is also found in the value of the guarantee to the purchasers of the municipal bond. The improvement in the security of the bond purchaser depends on the capital of the guarantor and the other commitments accepted by the guarantor; any change in the credibility of the guarantor will affect the market value of the bond. Similarly, in a private market for deposit insurance, any decline in the perceived credibility of the guarantor could generate liquidations of deposits.

FEASIBILITY OF PRIVATE DEPOSIT INSURANCE

Deposit insurance is unusual because it involves the potential for losses so widespread and so linked to one another that they would be collectively uninsurable by private sources. However, at least conceptually, the current deposit insurance could be subdivided either by type of risk or by layer of exposure, and the coverage apportioned between private and public insurers on one or other of these principles, or both. It seems important, therefore, to begin by distinguishing the different causes of institution failure and then consider whether and to what extent these individual hazards differ as to their insurability by private insurers. Whether private insurers were willing to provide named-peril or all-risk deposit insurance, they would need to limit their total exposure per risk, and might wish to protect against an unmanageable frequency or concentration of loss by offering only layers of excess rather than primary insurance. The following discussion considers the factors that would define the contours of the risks exposure that might be privately insurable.

Types of Hazards

The feasibility of private deposit insurance depends on whether the risks insured can be defined and limited sufficiently to permit sound underwriting decisions. In addition, the risks to be assumed clearly must not be so large that insurers cannot assemble sufficient capital to cover the loss exposure.

At least four different causes for insolvency or failure of financial institutions can be identified. The first three would appear to be readily insurable by the private market, at least to some extent: outside fraud or theft, misappropriation by insiders, and normal management failure. The fourth--macroeconomic crisis--is less clearly insurable by the private market. However, private insurers may participate even in that risk, because it would appear to involve fundamentally the same hazards against which securities accounts and money market mutual funds are now being insured.

Robberies and fraud by outsiders. Although robberies and frauds are fairly common occurrences and have caused the collapse of some small institutions, they rarely involve a sufficient proportion of an institution's assets to cause insolvency. Nevertheless, the risk does exist. The institution's losses from such occurrences may already be protected by the standard forms of bankers' blanket bonds, depending on such matters as, for example, whether the loss can be said to have occurred on the premises or through forgery (Fields 1969, 318). However, the blanket bond coverage runs to the institution, not its depositors; therefore deposit insurance is needed to cover them for risk of insolvency resulting from such events. Obviously, the deposit insurer would assert a claim to the proceeds from the blanket bond cover (e.g., Hartford Accident & Indemnity Co. v. FDIC, 204 F.2d 933 (8th Cir. 1953)).

Presumably, if the set of risks now covered by FSLIC deposit insurance were unbundled and divided between private and government insurers, coverage for this risk, up to a specified limit per account or per institution, could be provided by private interests. Individual insolvencies from this type of hazard would seem to be independent events unlikely to cascade into widespread failures. Therefore, there is little risk that an inordinate number of ventures within the risk pool would all fail, and an affordable premium based on this balancing of risks should be achievable.

Misappropriation of funds by insiders. The same should be true for this second type of hazard, although embezzlement by employees and dishonest management are fairly significant causes of bank failures.

The institution generally is covered against losses from this hazard by fidelity bonds, the proceeds from which would tend to avert insolvency. Very large misappropriations, however, can easily exceed the amount of the bond. For example, FSLIC regulations require a maximum bond against such events of only $3,000,000 (12 C.F.R., 563.19). As with the first hazard, a private market should emerge to cover depositors against insolvency resulting from this type of event. A given incident presumably would be an independent occurrence, not sparking other failures, and therefore the pool of institutions insured would represent diverse risks. Moreover, with both types of fraud, it should not be difficult to calculate the probability of failures from existing FSLIC and FDIC records.

Normal management failures. This type of hazard includes causes of failure such as poor lending judgment, acceptance of undue risks, mismanagement of liquidity, excessive costs, overinvestment in fixed assets, and the rest of the standard litany of bankruptcy. However, these losses might be produced by a combination of not only managerial incompetence and bad luck, but also business cycle fluctuation. To that extent, the hazard potentially could be widespread. It might be necessary to define this risk as one occurring only within "ordinary" business cycle fluctuations, those of, say, an amplitude experienced since 1945. Under coverage so defined, if more extreme macroeconomic conditions were experienced, the private guarantee would cease, and the federal guarantor would then be at risk. The precision with which such coverage could be defined and related practical problems are discussed below.

Private insurers should be able to estimate the frequency of management failures under normal circumstances from FSLIC and FDIC historical data, and thus calculate risk. However, to the extent that financial institutions will be less regulated in the future, insurers might have to extrapolate a new failure rate in such an environment by making assumptions as to the role that the incrementally diminished regulation played in the experienced failure rate. Certainly, a composite of failure rates among unregulated financial firms (e.g., factoring firms, auto financing companies, and so on) and among other businesses of comparable size, capitalization, and age should provide conservative limits for such exposure (again, assuming coverage was limited to normal business conditions).

Failures of national macroeconomic policy. This category of institutional failures would include insolvencies induced by, or occurring during, severe economic depression, monetary contractions, and the like. It seems clear that some or all of the risks of insolvencies occasioned by such events would have to be assumed by the federal guarantor because the concentration of simultaneous failures would be so great. Alternatively, private insurers might judge the probability of such cataclysm to be so remote (particularly if a federal backstop is present) that they would agree to participate in some layer of the guarantee against such risks.

In the extreme, this is a risk of recurrence of the type of financial crisis experienced in the 1930s (which brought deposit insurance into existence), that is, the risk of a widespread attempt to convert deposits into cash. A massive liquidation of deposit accounts forces depository intermediaries to liquidate their own portolios, which in turn leads to insolvency. A crisis generated in this way need not result from any real increase in the risk of assets held by depository intermediaries; it can be purely a crisis of confidence.

A crisis of confidence that precipitates a massive liquidation of deposit accounts constitutes catastrophic, and largely nondiversifiable, risk. Perhaps the only attractive feature of this kind of risk is that if a credible guarantee can be provided by a government agency, the crisis of confidence that leads to massive liquidation can readily be averted. If this view of the source of the problem is accurate, little direct cost would be incurred by the government in providing insurance through a federal agency. The more manageable risks described above, which nonetheless impose real loss exposures, could be assumed at least in part by private insurers.

The real difficulty would appear to be defining the line between such macroeconomic failures and other normal failures which nonetheless are affected by economic conditions. For discussion of this problem, the risk of normal management failures described earlier can be further subdivided into three basic categories: default or credit risk, interest rate risk, and "pure" management risk. Although it is apparent that a crisis of confidence results in a nondiversifiable risk, it is not as simple a task to determine whether these individual hazards, which fall short of a general crisis of confidence, are diversifiable.

Pure or extreme interest rate risk cannot be diversified; it is a macroeconomic failure. However, within a wide band, depository institutions may protect themselves against interest rate risk to varying degrees, at least as they are now regulated. Hence, a significant increase in interest rates may have quite different effects on different institutions. This introduces diversification into interest rate risk. It may even be argued that institutions that become insolvent because of interest rate changes in a deregulated environment actually suffer from management failure rather than interest rate risk.

A similar argument may be offered about the diversifiability of credit risk. To the extent that individual institutions hold widely diversified loans and to the extent that large numbers of institutions do not all have large participations in the same loans (say, oil industry loans or loans to foreign countries), then credit risk should also be at least partially diversifiable.

Although both credit risk and interest rate risk can be at least partially diversified, they nevertheless may be in large part determined by the aggregate performance of the economy. If the economy experiences serious difficulties, this may generate both high interest rates and default rates. As recent experience indicates, these risks are highly interrelated.

The experience of the principal deposit insurance agencies--the Federal Deposit Insurance Corporation (FDIC) and the FSLIC--

and of the private mortgage insurance industry supports this characterization of the risk involved in deposit insurance. Tables V-1 and V-2 show incidence of claims and total losses incurred by the FSLIC and the FDIC since their inception. The deposit insurance agencies have experienced very few claims and very low losses in most years; however, as the economy has experienced high interest rates and unemployment rates, both the claims and the losses incurred by the agencies have accelerated dramatically. A similar pattern of experience apparently applies to mortgage insurers, but no industrywide data are available.

It is apparent from this evidence that as long as the economy is prosperous, few losses will be experienced by deposit insurers. However, as the economy deteriorates the prospect of a catastrophic loss arises. That risk is essentially not diversifiable.

Alternative Forms of Joint Public-Private Deposit Insurance

The matters presented thus far suggest that it is undesirable and infeasible to replace the current federal deposit insurance system with one that is completely private. Nevertheless, it would appear feasible to alter the present system to allow private participation. Some private insurance of the assets is already held by S&Ls through mortgage insurance, which has worked effectively to date because of a constructive package of regulations that ensure the viability of the mortgage insurance contract.

Table V-1. Federal Savings and Loan Insurance Corporation Assistance

	Number of Cases	Assets (Millions)	Cost of Assistance (Millions)
1982	77	$28,360.7	$1,131.2[a]
1981	30	13,882.6	987.9[a]
1980	11	1,457.7	166.6[a]
1970-79	43	2,688.7	235.0
1960-69	43	1,670.6	103.9
1950-59	4	24.5	0
1940-49	27	48.9	3.3
1935-39	13	23.1	1.9

[a] Estimated current value of assistance; all other years represent net outlays. Thus, figures for 1976-1979 may be reduced as loans from the Federal Savings and Loan Insurance Corporation are paid off.

Source: Federal Savings and Loan Insurance Corporation.

Table V-2. Federal Deposit Insurance Corporation Selected Data for Failed Banks Requiring Disbursements

	Number of Cases[a]	Deposits (Millions)	Losses[b] (Millions)
1982	42	$9,900.0	$1,069.0
1981	10	3,826.1	759.6
1980	10	216.3	24.4
1970-79	76	5,129.0	129.1
1960-69	43	283.7	8.9
1950-59	28	66.6	3.0
1940-49	99	235.0	6.3
1934-39	312	293.6	18.5

[a] Data include both payout and assumption cases.

[b] Disbursements, loss recoveries, and estimated recoveries. Data for active cases are based on loss estimates.

Source: Federal Deposit Insurance Corporation. 1981 Annual Report. Washington, D.C.: Government Printing Office, 1982, Vol. 1; Federal Deposit Insurance Corporation. Unpublished data, 1983.

Moreover, existing coverages for certain debt securities and money market funds suggest that private insurers are willing to assume financial risks closely resembling deposit insurance. Therefore, it should be possible to widen the scope of S&L risks covered by existing private guarantors and to permit new private organizations or markets to emerge that would redistribute risk within the financial intermediation industry. Private guarantors could be existing casualty insurers or they might be depository institutions acting through some form of mutual insurance facility, most likely being reinsured by private commercial insurers.

As indicated above, no joint public-private deposit insurance program can operate effectively without a clear delineation of which guarantors are responsible for specific portions of the total risk. The risk might have to be divided by type of risk assumed, and undoubtedly also would have to be apportioned into layers, with the federal guarantor perhaps taking a lower, high-frequency layer, as well as assuming some form of ultimate guarantee for catastrophic events. Under that plan, private guarantors would then accept an excess layer of risk (subject to stop loss) and base premium prices on their estimates of the risk of individual institutions.

Regardless of the specific method chosen for dividing risk by class or into layers and the identity and organizational form which emerges for private guarantors, they would, in turn, almost certainly have to be subject to some minimum regulatory oversight--presumably by the same authorities that regulate the depository institutions. A number of possible ways to apportion or layer risk, structure guarantors, and set guidelines for those guarantors are discussed below.

Mechanisms for limiting loss exposure. For private guarantors to participate in the deposit insurance system in any meaningful way, there must be objective criteria for defining when the insured event has occurred--that is, for determining when an institution has failed. If private guarantors are to expose their capital in a private deposit insurance market, they cannot rely on the sole discretion of government regulators to determine when individual institutions have failed. However, when a large number of failures is a prospect, it is probably unreasonable and undesirable to compel regulators to forego discretion in determining when to close institutions. Therefore, it would probably be necessary to define a rule, based either on book or market values of assets and liabilities, that determines when an institution has failed. That rule could then be used in either of two ways. One possibility is that the private insurer would have the right to cancel insurance when the net worth measure reached the prescribed limit, presumably zero; if the federal insurers did not close the institution at that time, the private insurer's obligation would be terminated;

if it did close the institution, the insurer would pay any legitimate claims.

Alternatively, the rule would only be applied when failures remained within some upper bound. If failures--as measured by the number of institutions, proportion of the insured population, or total losses involved--exceeded some limit, then the regulators would have the right to use discretion in enforcing the rule. Moreover, this rule would presumably also be directly linked to the limit that would be placed on the loss exposure of private guarantors. For example, a simple rule might be that institutions are determined to have failed, according to specified criteria, as long as the number of failures does not exceed some percentage of the insured population; private guarantors would be responsible for some of the losses incurred by those institutions. However, this rule might not be sufficient if private guarantors felt that losses even on this proportion of the insured population were unbounded. It would also be necessary to impose a limit on the dollar losses to which private guarantors would be exposed.

Once criteria that define failure in an objective manner for that portion of the total risk that is the responsibility of private guarantors is established, it would be necessary to consider alternative ways to divide the risk into layers. Basically two methods could accomplish this. One is to impose a stop loss, or an upper limit, on the loss exposure of private guarantors; the other is to allocate the insured deposit liabilities directly between private and government guarantors. It might well be necessary to use both methods.

A stop loss places an upper limit on the potential liability of an individual insurer or group of insurers. The stop loss can apply to an individual event, such as failure of a single depository institution, or it can apply to all events occurring in a period of time. Stop losses for deposit insurance might well include both types of restrictions. The limit on losses from an individual failure would probably be needed as a result of the practical difficulties involved in constructing a rule that defines failure when real economic net worth is zero. If any operational rule were a highly imperfect measure of economic value, the stop loss on individual failures would limit the responsibility of the private guarantor for shortcomings in the rule. An aggregate stop loss for a given time interval would be necessary to limit the responsibility of private guarantors to cases that were not deemed to be catastrophic losses.

Another way to layer the coverage is to provide deposit insurance on some portion of the current $100,000 limit for individual accounts and to reserve the remainder for federal insurance. One way this might be done is to restrict private coverage to the initial portion of the $100,000 insurance limit; for example, the first $10,000 could be private coverage and the remaining $90,000 federal coverage.

This would mean that in order for an institution to obtain the $90,000 federal coverage, the private insurance must also be utilized.

However, insurance at the lowest and most certain loss level is probably the least attractive to the private insurance industry because of higher costs. An alternative is for the government to provide insurance on an initial layer of deposits--say, $10,000--and then allow the private market to offer additional insurance on an optional basis. Because not all insured accounts would contain over $10,000, the frequency of claims against private insurers for that layer would be lower.

In any case, stop losses on the total liability of private guarantors would probably be needed. The government presumably would have to assume liability for anything beyond the stop loss, if one existed, or for any losses if a private guarantor failed. Hence, there would still be a total guarantee for all insured depositors. The first of these two procedures-a privately insured primary layer--involves no fundamental change in the current availability to depositors or insurance, while it may introduce some market discipline into the insurance process. The second procedure would substantially reduce the extent of the automatic federal guarantee of deposits and, unless private excess insurance were mandated, would make a large portion of the guarantee optional.

In any scheme for constructing layers of risk, it is important that there be significant co-insurance by those parties whose actions influence the magnitude of loss exposure. Owners of institutions are at risk because their equity capital is exposed. If regulators continue to perform the monitoring and screening functions that are normally a part of insurance underwriting, then federal guarantors should be exposed to some risk in all potential insurance claims. It seems that any system for layering risks that allocates most of the loss exposure to private guarantors during normal conditions would be unworkable. This probably means that as long as the underwriting process remained largely the domain of the regulators, the plan where private insurance represents an optional second layer would probably be a more practical alternative. Even in this type of system, private guarantors would need control of underwriting or pricing judgments for the risks they actually take on.

Mechanisms for distributing loss exposure. Once a system for dividing the deposit insurance risks between the government insurance agency and the private marketplace has been developed, it is necessary to consider the mechanism that might evolve for distributing that risk across individual private insurers. This might be handled in a number of possible ways. The basic questions that must be addressed are: what private entities can and should bear the deposit insurance risk? How should private risk-bearers be organized?

One possible way to distribute the risk is to allow private insurance companies, specifically casualty companies and mortgage insurance companies, to offer layers of insurance to depository institutions. The principle advantage offered by these companies is the expertise necessary to design an effective insurance program. The only question is whether they have the capital base or the capacity necessary to provide significant amounts of coverage. It is difficult to provide a conclusive answer to this because, at this juncture, quantifying the actual loss exposure involved in deposit insurance is difficult. The loss exposure depends on the ability to write a clear contractual agreement that defines what constitutes a failure. If this definition must rely on book value or on very imperfect measures of market value, losses could be very large. Moreover, if severe difficulties are involved in arranging cooperation between insurers and regulators, then this could have a significant effect on losses as well. However, if these problems are too serious, they would probably threaten the viability of any private participation in the deposit insurance program.

One way to expand the available capital base is through insurance pools and reinsurance arrangements (the latter being a nearly universal tool of the casualty insurance business). Because of the large amounts of deposits that would be involved in any private program, pools would likely be formed by both domestic and foreign underwriters with worldwide reinsurance agreements to share the coverage. However, as indicated in the discussion of nuclear accident insurance, even world reinsurance capacity has definite limits. Nonetheless, through the use of insurance pools and reinsurance, new insurance facilities should emerge in the market to expand the available stock of capital.

One obvious group of insurers is the depository institutions themselves. It should be feasible to insure within the depository industry itself a large portion of all risks except that of widespread insolvencies following a general macroeconomic crisis. As a practical matter, the current deposit insurance system operates as a mutual self-insurance system by the depository institutions, except in the case of catastrophic loss. Therefore, a joint public-private insurance program involving only a private mutual insurer would constitute little more than formal privatization of the existing structure of ownership, control, and management of the FSLIC (or the FDIC).

There are a number of other ways in which a private insurance organization that is funded or supported by the insured depository institutions could be structured. One possibility preserves the advantage of having established insurance firms participate in the private deposit insurance market. Under this plan, private insurance companies would write the direct insurance but reinsure their risks with a depository intermediaries' mutual organization.

Alternatively, the depository intermediaries might choose to form their own competing insurance underwriters and offer deposit insurance directly to their industry. These might be stock companies with extensive reinsurance to expand the capital base, or they might be mutual companies where the participating institutions agree to tax themselves through retrospective assessments to cover the losses generated if and when a participating institution fails.

This mutual insurer alternative has some natural advantages, including ready access to substantial amounts of liquid funds, direct self-interest in preventing failures and liquidity crises, and extensive experience and first-hand information regarding the nature and extent of industry problems. However, it does not make additional capital available to the industry and could not be used for catastrophic risk.

A close parallel to this type of cooperative insurance of financial firms is the Securities Investor Protection Corporation (SIPC). The SIPC is a nonprofit membership cooperation funded by the securities brokers and dealers who are required to be members. It was created by Congress in 1970 for the purpose of preserving investor confidence by protecting securities accounts at member institutions. Currently, the SIPC provides protection to a maximum of $500,000 against losses that customers might incur if a member is unable to meet obligations. At the present time, claims for losses involving cash rather than securities are limited to $100,000.

The principal source of funds during the first seven and one-half years of the corporation's existence was provided by assessment of SIPC members, based on the relative share of gross revenues generated by their operations. Although the SIPC currently maintains a small fund of reserves against potential losses, assessments based on gross revenues may be reinstated at any time as required to protect investors.

Parenthetically, it is worth noting that some brokerage firms also have private insurance coverage above SIPC levels. On this evidence, it would seem that depository institutions should be able to obtain, at affordable rates, similar excess insurance for deposits above $100,000.

Although distinct advantages are associated with protection offered by industry mutuals or cooperative agreements, it should be noted that the capital backing their commitments does not expand or supplement the industry's existing capital base. Instead, the offered protection relies on the gains from dispersing the effects of failures among all members of the mutual. Such a role is most effective when confined to the responsibility of handling only small numbers of failures. Consequently, additional private commercial insurance capacity would seem desirable. Of course, government protection would continue to be required to maintain public confidence concerning the solvency of the entire system.

It does not appear that any particular form of organization for a private guarantor of deposits has any inherent and overwhelming advantage over the others. Any form of organization would have to have adequate capital available to cover the risks assumed, and it would have to contain an appropriate incentive to engage in adequate underwriting and to price competitively. However, there is no reason to believe that it should be necessary to limit private structures in advance.

Pricing. The approach to pricing private deposit insurance would depend critically on whether the product is structured as a retrospective assessment agreement, such as that used by the SIPC, or as one with premium levels designed to generate adequate ex ante reserves, as in mortgage insurance. With a retrospective assessment plan, premiums are not collected and held by the insurer for future losses; instead, very low levels of reserves are maintained by the insurer. If large losses occur, a retrospective assessment is made on all participants in the scheme.

There is a severe potential adverse selection problem in the retrospective assessment plans. Constraints would have to be imposed on the ability of participating institutions to withdraw from the agreement. If institutions could exercise complete freedom about the timing of their participation in insurance, joining and withdrawing when they choose, the system would probably be plagued by adverse selection problems. Mutual long-term commitments might be required, as in mortgage insurance, for example, where the insurer forgoes the right to cancel the policy, and the insured is compelled to renew until the leverage in the loan is reduced below a minimum that is mandated by regulation.

For a joint public-private insurance system to constitute a real improvement over the current system, it is essential that some competition in price setting be established. This would seem to require that there be at least several competing private deposit insurance companies, and preferably even more. Each private insurance company may well seek reinsurance throughout the industry, but there should be competition in the determination of direct rates for individual financial intermediaries.

Presumably, the government should not require savings and loan associations to form a single mutual insurance facility and discourage commercial insurers from entering the field. Although a single mutual insurer would represent the simplest form of privatization of the present system, it would not be an attractive alternative, because the single mutual insurer would operate as a pricing monopolist. Moreover, such a monopoly would add a collusive element to the entire market for the services of insured depository intermediaries. The insurance monopoly would require most institutions to contribute financial support for others if they fail. This kind of redistribution within the industry would create both a strong incentive and a potentially effective mechanism for participating institutions to attempt to set prices and otherwise limit competition so as to minimize the chance of failure. This would have obvious negative antitrust implications and would not be in the best interests of consumers.

A number of institutions may not be insurable by the private market. These institutions would have to be able to acquire insurance from the federal deposit insurance agency if they were not closed by the regulators. In practice, this could mean that there would be some opportunity for choice of private versus public insurance by many institutions.

If federal insurance is underpriced in such a market, even insurable risks will try to find ways to avoid private insurance and seek protection from the federal agency. This kind of adverse selection would limit the potential usefulness of private participation in deposit insurance. However, equilibrium prices for risk by the federal insurance agency might be so high as to effectively force the institutions that cannot be insured in the private market into insolvency. This kind of market discipline would tend to limit the flexibility of the federal regulator and insurer in determining what constitutes failure. It also may be necessary for regulators to impose a requirement that the institution exhaust all private avenues in search of affordable coverage before receiving eligibility for complete federal insurance.

Regulation of insurers. If a private deposit insurance market were permitted to evolve, some minimum overview by federal regulators would be advisable. However, because one of the goals to be achieved by the contemplated privatization of deposit insurance is to reduce overall federal regulation, a new and complex regulation of private insurers should be avoided.

Commercial insurers, including mortgage insurers, are now regulated primarily at the state rather than the federal level. Most of the regulatory system for insurance companies is designed to guarantee that capital levels are not misrepresented and to protect consumers against what is perceived to be the prospect of adverse effects of intense competition. This means that regulators set minimum prices for many insurance products. This kind of price setting requires a regulatory process for determination of a fair rate of return, much like that imposed on public utilities. However, many insurance products are written in the "surplus lines" fields, where premium rate regulation is not imposed by the states. Indeed, rate regulation is generally imposed only where the purchasers are individuals or small businesses, arguably in need of such protection. Depository institutions, either individually or collectively, should be able to negotiate premiums on more or less equal footing with private insurers. Therefore, there is little reason to believe that complicated pricing regulation is warranted.

A better view is that federal regulators of depository institutions should exercise regulatory oversight over insurers only on such matters as necessary to ensure that adequate security exists for claims. In doing this, the regulators should employ, to the extent possible, the body of regulatory guidelines already developed for insurers and reinsurers by the National Association of Insurance Commission (NAIC) and by other federal agencies. The U.S. Department of Treasury, the Maritime Administration, the Interstate Commerce Commission, the Coast Guard, and the Federal Maritime Commission, to name a few, have developed standards for, and by application lists of, surety companies and insurers authorized to provide financial responsibility for public liabilities arising under their respective regulatory programs. A similar approach should be adopted in this case. Indeed, to the extent the private insurers that come forward to offer deposit insurance are the same, substantial reliance should be placed on the information already provided by these other agencies as to the quality of security offered by such private insurers.

Adverse selection potential. At least two possible sources of adverse selection are associated with deposit insurance. First, at any given moment the better risk institutions might tend to elect not to be insured at a premium level that represents the average risk in the marketplace, and might withdraw from a market priced accordingly. Second, the same potential intertemporal problem exists as encountered in mortgage insurance. If deposit insurance were made available and priced on a year-by-year basis with rights to renew and cancel retained by both the insurer and the insured, then depository institutions might choose to be insured only in times of high risk, while insurers would be inclined to cancel insurance during such times.

The current federal deposit insurance system solves both adverse selection problems simultaneously by requiring that all federally chartered commercial banks and savings and loans, and most state-chartered institutions, maintain insurance coverage. This requirement might have to be retained to provide a constant pool of "good risks" with which insurers could balance their exposures. Moreover, as indicated in the pricing discussion above, the federal guarantor might have to stand ready to insure an individual institution to the extent that the private market judged it to be too poor a risk.

Right of cancellation. The freedom of private insurers to cancel coverage is essential, but might have to be limited in order to retain the depositor confidence in institutions that is a hallmark of the current federal system. While some consideration needs to be given to an appropriate minimum cancellation notice period, in principle this concept should present no real difficulty.

Regulatory agencies, both federal and state, routinely require insurers to remain at risk during a specified notice period.

SUMMARY

Some participation by private insurers in deposit insurance appears to be both feasible and desirable. A private role in deposit insurance should reduce both the regulatory and financial burden on government institutions, and market-oriented pricing and management of at least some layers of deposit insurance should have salutory effects on the insured financial intermediaries. Moreover, the broad range of insurance products that have evolved to cover large catastrophic events, as well as risks of various financial enterprises, demonstrates that private insurers possess the versatility and capacity necessary to participate in deposit insurance. Inevitably, however, the resources of the highly interrelated international insurance and reinsurance markets would be called on to assemble the coverage.

A significant and continuing role for federal agencies in deposit insurance, nevertheless, is essential to maintain public confidence and ultimately to provide adequate capacity to insure against truly catastrophic losses. Apportioning the risks between private and federal insurers by class of hazard insured and by layer of loss would appear to be a definitional task familiar to commercial insurers, and thus not insurmountable difficulties. It is most likely that federal insurers would have to retain liability for the lowest and most certain level of losses, while private insurers would offer coverage for some layers of loss exposure.

A number of practical issues would arise from a dual insurance scheme. For example, private insurers and federal regulators would have potentially conflicting interests in declaring the failure of an institution. This could be resolved by using precise objective criteria to define relative rights and responsibilities in advance. Other practical considerations, such as the extent to which insurers would accept limitations on the right to cancel insurance or to refuse coverage for institutions that are poor risks, are not readily answerable until the private market is developed. In any event, there is little reason to believe that such problems would present insurmountable obstacles to a useful private role in deposit insurance.

SECTION VI

RETHINKING REGULATORY STRUCTURE

(521)

The current structure of financial regulation developed in a piecemeal fashion over decades. Each new type of institution--commercial banks, savings and loan associations, credit unions--resulted in a new set of regulators. Initially, depository institutions were creatures of the states, with each state establishing a chartering and supervisory authority; state-run deposit insurance funds date back to the 19th century. A federal role was introduced in the 1860s with the establishment of federally chartered banks under the Comptroller of the Currency. The Federal Reserve Act of 1913 set up a further layer of control. As a result of the Great Depression, yet another federal agency was established to provide insurance of deposits at commercial and savings banks. At about the same time, a new law created federal chartering of savings and loan associations (S&Ls) to complement the existing state-chartered institutions and established federal deposit insurance for S&Ls. Much later, Congress set up a federal chartering authority for credit unions, and in 1970 that agency was vested with deposit insurance authority as well.

This protracted and essentially unplanned development process has had two important consequences for the current debate on regulatory reform. First, the pattern of control that emerged involves substantial duplication of authority. Multiple agencies typically share responsibility for regulating a particular firm, as in the federal-state oversight of state-chartered, federally insured institutions. Also, different agencies perform the same functions for different firms in the same industry, as illustrated by the division of responsibility between the Comptroller of the Currency and the Federal Reserve for national and state member banks.

The second consequence is specialization in the structure of the financial services industry and in its regulation. No competition was expected between industries, only within the thrift, bank, or securities sectors. With few exceptions, the regulator for one industry has no authority over firms in another. Savings and loan associations have one federal deposit insurer; banks have another.

Over the years, a number of forces for change have developed. The current structure of overlapping, parallel, and specialized agencies has proven inadequate to deal with some recent problems. Duplication of control implies higher administrative costs and a greater regulatory burden on firms. Shared responsibility among agencies with differing objectives has led to conflict. Broadened asset and liability powers have engendered new competition between the banking and thrift (savings and loan associations and mutual savings banks) industries, highlighting differences in regulation and supervision. And the competitive pressures coming from the unregulated financial sector have spurred the effort to alleviate regulatory rigidities that hamper the responses of thrifts and banks.

Proposals for structural change have emerged in three broad areas. First, the federal-state relationship--the hallmark of the dual banking system--may need streamlining to cope with a swiftly changing financial environment. From the very beginning, addressing the proliferation of federal banking regulators has been the second topic in the reform debates. The third is the issue of consolidating the banking and thrift regulatory structures, a reform intended to accommodate and facilitate interindustry competition. Although a merger of the insurance agencies is the subject of this section, it cannot be treated independently of the other elements of reform. In fact, rationalization of regulation within each industry must precede (or, at least, accompany) a consolidation across sectors.

To develop the consolidation question, the section first reviews the roles of the three deposit insurance agencies in the regulatory scheme, discussing the differences in original objectives, powers, structure, and current operation. Next, the issues that bear on the feasibility of consolidation are analyzed, followed by a summary of the history of reform proposals.

THE STRUCTURE OF FEDERAL DEPOSIT INSURANCE

Three federal agencies provide insurance of deposits for depository institutions. Although their roles are essentially similar, there are important differences in internal organization, mission, size, and practice.

Establishment and Control

The Federal Deposit Insurance Corporation (FDIC), first of the federal insurance funds, was established in 1933 by an amendment to the Federal Reserve Act of 1913. Its mandate was to protect depositors in closed banks and, more generally, to promote a sound and viable banking system. It was organized under its own governing authority, a three-member board composed of the Comptroller of the Currency and two Presidential appointees, one of whom was to serve as chairman and chief executive officer.

This measure of independence from the Office of the Comptroller of the Currency and the Federal Reserve Board resulted from the historical evolution of the banking regulatory apparatus. From its inception in 1863, the Office of the Comptroller of the Currency had been in charge of the chartering, regulation, examination, and supervision of national banks; with the exception of chartering, the Federal Reserve Board since 1913 had performed these functions for state member banks. The vertical separation of the FDIC from the other two federal regulatory bodies, in contrast later with the regulatory structure of thrift institutions, was necessary to avoid favoring either existing organization by granting exclusive control over the insurance function. This complexity within and across industries has been a central focus of the reform debates.

The FDIC was required to insure all national member banks, and all nonmember state banks or trust companies on a voluntary basis subject to the approval of the state authorities and upon examination and approval by the FDIC. Even though all member banks received FDIC insurance with their national charter or Federal Reserve membership, the FDIC did have the power to terminate a member bank's coverage, which ended that bank's eligibility for Federal Reserve membership. Under the original legislation and the amendments contained in the Banking Act of 1935, the FDIC was granted regulatory, examination, and supervisory authority over all banks it insured, although in practice it accepted the reports of the Comptroller of the Currency on national member banks and those of the Federal Reserve Board on state member banks. In addition, the Banking Act of 1935 consolidated the insurance funds for mutual savings banks into the FDIC fund.

Permission for the FDIC to conduct its own examinations of national or state member banks had to be obtained from the Comptroller or the Federal Reserve Board, respectively, even though the FDIC had the statutory right to conduct examinations. The responsibility for examination as well as supervision of state nonmember banks rested clearly with the FDIC, although this jurisdiction was shared with state banking authorities. The power to close a bank remained with the chartering body--the Comptroller in the case of national banks and the state authorities in the case of state member and nonmember banks.

This convoluted arrangement was not a product of design. Congress did not initially intend the FDIC to be a primary bank regulator. The 1933 amendment required all insured banks to become members of the Federal Reserve System by 1936, thereby eliminating the FDIC's supervisory role. The 1935 act extended the deadline to 1941. Finally, in 1939 the membership requirement was repealed, thus making permanent the existing makeshift system.

The Federal Savings and Loan Insurance Corporation (FSLIC) was established in 1934 under the National Housing Act. Control and management of the FSLIC were vested in the members of the recently created Federal Home Loan Bank Board (FHLBB), however, who were named trustees of the insurance agency. Its mandate was to insure the accounts of all federally chartered savings and loan associations. State-chartered institutions, including those not part of the Federal Home Loan Bank System, were eligible for insurance if they paid premium charges and examination fees. They were also required to comply with certain other basic stipulations imposed on federal associations.

Creation of the FSLIC in 1934 completed the regulatory framework for savings associations established under the Federal Home Loan Bank Act of 1932 and the Home Owners' Loan Act of 1933. The 1932 act provided a credit reserve for thrift institutions by setting up 12 federal home loan banks capitalized by member institutions and the U.S. Treasury and authorized to lend limited amounts without collateral. That act established the FHLBB with regulatory and supervisory powers over the home loan banks. The 1933 act gave the FHLBB responsibility for chartering, regulating, examining, and supervising federal S&Ls. In addition, the FHLBB was authorized to promote the organization of savings and loan associations, and money was appropriated for that purpose. Although that provision remains, in 1956 the FHLBB formally announced that it was discontinuing promotional activities.

In 1970, Congress amended the Federal Credit Union Act to establish federal credit union insurance under the National Credit Union Share Insurance Fund (NCUSIF). Coverage was mandatory for all federal credit unions and voluntary for those operating under state charter or under the jurisdiction of the U.S. Department of Defense. State-chartered credit unions also had the option of insurance under the state share insurance plans.

The NCUSIF was organized within the U.S. Department of the Treasury under the direction of the administrator of the National Credit Union Administration (NCUA), replaced in 1978 by the NCUA board. The NCUA regulates and examines both federal and state NCUSIF-insured credit unions, in addition to chartering and supervising federal credit unions. The law also attempted to minimize the burden of examination by mandating that the pre-existing federal examination be restructured to be usable for insurance purposes, and that state examination reports be used by the NCUA to the maximum extent possible. If a state-chartered credit union is found to be engaged in unsafe or unsound practices according to NCUA or state authority regulations, the NCUA has the authority to revoke share insurance. The functions of NCUSIF initially included the provision of loan assistance to credit unions in difficulty, but this activity was taken over in 1978 by the Central Liquidity Facility (CLF), established under the Financial Institutions Regulatory and Interest Rate Control Act. The facility was organized as a government corporation within the NCUA, capitalized by its member credit unions, and managed by the NCUA board. Membership in the CLF is open to all insured and noninsured credit unions on a voluntary basis. Credit unions that do not choose to become regular members of the CLF can access the facility through an agent member.

Coverage and Powers

Deposit insurance today is a pervasive feature of the financial system. Most depository institutions and nearly all retail deposits are covered by federal deposit insurance (see Table VI-1).

Since 1980, deposits at insured banks, thrifts, and credit unions have been covered up to $100,000 under virtually identical provisions of law. But this has not always been the case. FDIC-covered accounts at first were 100 percent insured for the first $10,000, 75 percent for the next $40,000, and 50 percent for the balance. In 1935 this system was discarded in favor of a flat $5,000 limit

Table VI-1. Total Deposits by Type of Institution, June 30, 1982
(Dollar Amounts in Billions)

Insurance Status	Savings & Loan Associations	Commercial Banks	Mutual Savings Banks	Credit Unions	All Institutions
Federally Insured	$527.5	$1,302.6	$139.7	$64.3	$2,034.1
Not Federally Insured	11.2	0.7	8.2	6.6	26.7
Total	538.7	1,303.4	147.9	70.9	2,060.9

Sources: Federal Home Loan Bank Board. "Savings and Loan Activity in December." Photocopy, January 28, 1983, tables 3, 5; Federal Deposit Insurance Corporation, National Credit Union Administration, and National Association of Mutual Savings Banks. Unpublished Data, 1983.

(now $100,000), as this approach would provide coverage for 98 percent of all deposits. Coverage at FSLIC-insured savings and loan associations also began at $5,000 and was subsequently raised in step with FDIC insurance. Reimbursement to FDIC-insured account holders was to be immediate. In contrast, the original FSLIC arrangement for S&L depositors (since changed to conform with the FDIC) authorized payment of 10 percent of the insured amount at once in cash, 50 percent of the remainder in one year, and the balance in three years. The compensating factor for S&L depositors was thought to be the higher desposit interest rate relative to the commercial bank rate.

When the NCUSIF was established, coverage was set at the $20,000 level then prevailing for banks and S&Ls. That insurance was also raised in stages to the current $100,000. In case of liquidation, payment to credit union members is immediate and complete, consistent with the original FDIC and amended FSLIC provisions.

To facilitate liquidation, the FDIC initially could organize a new bank to assume the insured deposit liabilities; in 1935, it received authority to take other measures to avoid liquidations. Until 1982, however, the FDIC statute was predisposed toward merging or closing a weak institution rather than providing assistance on a continuing basis (without merging or closing). The Banking Act of 1935 permitted such assistance only when the continued existence of the bank was deemed essential to the financial needs of the community. (There was no comparable restriction on the FSLIC.) Given the large number of depository institutions in most communities, this determination was difficult to make. The Garn-St Germain Depository Institutions Act of 1982 brought the FDIC statute into conformance with the more liberal FSLIC provisions.

The original legislation (title IV, section 407(b), National Housing Act, as contained in The Statutes At Large) authorized the FSLIC to terminate the insurance of an institution five years after notification, "for violation of any provision of this title, or of any rule or regulation made thereunder." This was interpreted in the majority report of the House Committee on Banking and Currency as a basis for issuing safety regulations. The FSLIC has various powers to deal with the problems of weak associations, including contracting with another insured institution to take over the accounts of the institution in default and creating new federal S&Ls with the assets of the old institution. The NCUSIF's powers to merge or liquidate parallel those of the FSLIC.

Financial Structure

The two older agencies started with funds advanced by the federal government. Those sums have since been repaid; today the balances in all three insurance funds represent only the accumulated contributions of insured institutions.

The initial capitalization of the FDIC included $150 million of government-subscribed stock, as well as the required subscriptions of Federal Reserve banks and member and nonmember banks. The entire amount ($289 million) was repurchased, with interest, by 1949. The FDIC is authorized to borrow up to $3 billion from the Treasury, although it has never done so.

The FSLIC was established with a capital stock of $100 million, subscribed entirely by the Home Owners' Loan Corporation, another body under the FHLBB organized in 1933 to refinance home loans in danger of default. This sum, together with $43 million in interest, was paid back between 1950 and 1958. The FSLIC is also authorized to borrow additional funds as needed from the Treasury, up to $750 million.

Unlike the FSLIC and the FDIC, the NCUSIF was established without original capitalization or funding. The Treasury may make loans to the NCUSIF of up to $100 million if reserves fail to meet requirements. The Treasury is also in charge of the investment of that portion of NCUSIF reserves not needed for current operations.

Today, all three agencies charge insured institutions the same gross premium--1/12 of 1 percent of deposits per year. Initially, however, premiums were much higher; currently banks effectively pay fees that are substantially lower.

The FDIC insurance premium was set initially at 1/2 of 1 percent of total deposit liabilities, but was reduced to 1/12 by

1935. In 1950 the Federal Deposit Insurance Act established an assessment credit to insured banks of 60 (later 66-2/3) percent. Thus most of a bank's premium can be rebated, depending on the FDIC's expenses for the year, with resulting net premiums as low as 1/36 percent. For the 1950 to 1981 period, net premiums averaged about 1/24 percent after assessment credits, or half of the statutory gross rate.

The FSLIC insurance premium was initially set at 1/4 percent of the association's total deposits plus creditor obligations, and later reduced to 1/12 percent of total deposits. An additional charge of 1/4 percent (now 1/8 percent) could be imposed (but never has been) until the annual premiums of the FSLIC covered its losses and expenses, with a reserve fund equal to 5 percent of insured accounts plus creditor obligations at insured institutions (now 2 percent of total deposits). In 1962 the agency established a secondary reserve to increase the speed at which total reserves could be built up. Insured associations were obliged to make an annual prepayment into the reserve of 2 percent of the increase in withdrawable savings accounts for the preceding year less the value of any required federal home loan bank stock. In August 1973 prepayments to the secondary reserve were discontinued to eliminate the uneven pattern of premium payments, and in 1974 the Depository Institutions Act provided for the abolition of the secondary reserve over a 10-year period beginning in May 1974.

The annual NCUSIF premium was set at 1/12 of 1 percent of a credit union's total member accounts. At the time there was some debate as to whether a smaller premium would be adequate; the level of 1/12 was selected with the provision that the premium would later be reduced when the principal and interest on any government loans had been repaid and the amount in the fund was sufficient to cover normal operating expenses.

In 1982, a special premium of 1/18 of 1 percent of deposits was collected by the NCUSIF in addition to the regular premium. This resulted from a decision by the NCUA board in July 1982 to exercise its authority under the Federal Credit Union Act (section 202(c)(5)) to impose such an assessment when fund expenses exceed income. At the same time, the NCUA adopted the goal of maintaining its insurance fund at 1 percent of insured deposits, defined in the act (section 202(h)(2)) as the "normal operating level." These decisions followed a favorable response from the majority of federally insured credit unions that answered the NCUA's request for comments in June 1982.

Earnings on the assets of the insurance funds can provide a substantial share of the agencies' income. In recent years, both the FSLIC and the FDIC derived more than half of their cash flow from investment earnings; for the NCUSIF the share has been smaller. Until the recent problems of the thrift industry, income of the funds substantially exceeded expenses, contributing to their continued growth. The growth rate for the FSLIC and NCUSIF funds has exceeded that of the FDIC fund because of higher premiums collected. Nevertheless, the differences in the sizes of the three industries have meant a growing absolute disparity in the sizes of the funds. Table VI-2 traces the growth of the funds since their inception.

Although it must submit an annual report to Congress, the FDIC operates independently of the Office of Management and Budget (OMB). The annual budget of the FSLIC is subject to apportionment control by the OMB, whose estimates are based on the Administration's economic forecasts. Like the FSLIC budget, the NCUSIF annual budget is subject to OMB approval.

ISSUES IN CONSOLIDATION

The three deposit insurance agencies differ in their organizational structures and in the functions they perform. That suggests several alternatives for the form of a consolidated agency: two funds could be merged into the third, or an entirely new corporation with features drawn from each could take over some or all duties. A review of alternative possible structures for the new agency precedes the discussion of the issues in consolidation.

Legal Aspects

The statutes creating and authorizing federal deposit insurance involve three separate acts located at three different

Table VI-2. Assets of the Insurance Funds for Selected Years, 1935-1982
(Dollar Amounts in Millions)

End of year	FSLIC	FDIC	NCUSIF
1935	...	$ 306	...
1940	$ 24	496	...
1945	62	929	...
1950	88	1,244	...
1955	171	1,640	...
1960	354	2,222	...
1965	1,537	3,036	...
1970	2,903	4,380	...
1975	4,120	6,716	$ 47
1980	6,462	11,020	166
1981	6,302	12,246	175
1982	6,420	13,770	234

Sources: Federal Home Loan Bank Board. 1981 Annual Report. Washington, D.C.: Government Printing Office, 1982: table 3; Federal Home Loan Bank Board. Unpublished Data, 1983; Federal Deposit Insurance Corporation. 1981 Annual Report. Washington, D.C.: Government Printing Office, 1982: table 129; Federal Deposit Insurance Corporation. Unpublished Data, 1983; National Credit Union Share Insurance Fund. Annual Financial Report, Fiscal Year 1981. Washington, D.C.: Government Printing Office, 1982: 26; National Credit Union Share Insurance Fund. Unpublished Data, 1983.

places in the U.S. Code. Consolidation of the funds would necessarily involve new legislation. This could be accomplished in a relatively straightforward manner, because most of the original differences between the FSLIC and the FDIC have been eliminated through subsequent legislation. The more recent NCUSIF is generally consistent with the two older funds. Remaining differences, such as assessment rebates, budget status, form of governance, and Treasury borrowing authority, could be decided without prejudice to any institution (transition issues aside). Three issues would remain: the "vested interests" of FSLIC-insured institutions in the secondary reserve, the resolution of conflicting rules of insurance coverage, and the supervisory functions presently tied to the insurance functions.

The first issue pertains to sums paid by insured institutions into the FSLIC secondary reserve. Institutions retain certain rights to these amounts because, under certain circumstances, they may apply these amounts to future insurance premiums due. The issue may be moot, given section 126 of the Garn-St Germain Act, which provides that these interests become divested when "extraordinary financial conditions exist increasing the risk to the [fund]." In any case, it would not be difficult in new legislation to provide for withdrawal of institutions' previous contributions to the secondary reserve.

The second issue arises because the FDIC, FSLIC, and NCUA regulations on insurance are very similar, but not identical. For example, FSLIC insurance regulations (at 12 C.F.R. 570.12 (1982)) provide that a check drawn by an insured S&L on its demand deposit at another financial institution is covered by FSLIC insurance; no comparable rule exists in the FDIC or NCUA regulations. Another example is that the regulations of all three agencies provide for separate insurance of up to $100,000 for the interest of each beneficiary in a trust account, but only the FDIC regulations (at 12 C.F.R. 330.5 (1982)) make an exception to this rule in the case of trusts registered as investment companies. If the three agencies were consolidated, it would be necessary to identify all of the instances in which insurance coverage has not been identical under the separate regulations. New regulations for the consolidated insurance agency should probably "grandfather" coverage of accounts insured at the time of consolidation in any cases where coverage under the new regulations would diminish.

The third issue--supervisory functions--is more fundamental. Resolution depends in large part on whether a fund consolidation is part of an overall consolidation of the financial institutions' regulatory agencies, because a major reorganization would relieve the problem of overlapping jurisdictions. Otherwise, Congress would have to decide whether to leave the supervisory functions of the FDIC, FSLIC, and NCUA in a consolidated insurance agency or divide them among the remaining regulatory agencies (Comptroller, Federal Reserve Board, FHLBB, NCUA). No legal problems are inherent in separating the authority to regulate insured institutions from the function of insurance; this has already occurred, for example, in the regulation of FDIC-insured federal savings banks. But broad issues are involved in selecting the appropriate federal policy toward regulated depository institutions.

Powers of a Deposit Insurance Agency

The current structure of the regulatory environment is presented in Table VI-3, with the vertical levels representing the types of control exercised (chartering, supervision, insurance, etc.) and the horizontal divisions indicating the different depository institutions (state member banks, federal S&Ls, etc.). Each section therefore shows the agency having jurisdiction over that particular function and the institution represented by the row and column, respectively. Consolidation can be illustrated in this framework by indicating that the same agency has jurisdiction for one or more functions (rows) across all of the institutions.

It is then necessary to decide which functions should be performed by the consolidated agency, and whether the same set of functions should apply to all institutions. For example, the FDIC currently insures both member and nonmember state banks, but does not ordinarily examine the member banks. Should a new agency

Table VI-3. Structure of Depository Institution Regulation

Savings and Loan Associations

Function	Federally Chartered FSLIC Insured	State Chartered FSLIC Insured	State Chartered Non-FSLIC Insured
Chartering	FHLBB	State	State
Regulation	FHLBB	FHLBB, State	State
Examination	FHLBB	FHLBB, State	State
Supervision	FHLBB	FHLBB, State	State
Insurance	FHLBB	FHLBB	State
Liquidity	FHLBS, FRS[a]	FHLBS, FRS[a]	FRS[a], FHLBS[b]

Commercial Banks

Function	National Bank FRS Member	State Bank FRS Member	State Bank Non-FRS Member
Chartering	OCC	State	State
Regulation	OCC (FRB, FDIC)	FRB, State (FDIC)	State (FDIC)[c]
Examination	OCC (FDIC, FRB)	FRB, State (FDIC)	FDIC[c], State
Supervision	OCC (FRB, FDIC)	FRB, State (FDIC)	FDIC[c], State
Insurance	FDIC	FDIC	FDIC, State
Liquidity	FRS	FRS	FRS[a]

(continued)

Agencies in parentheses have the authority but normally do not exercise it.

CLF = Central Liquidity Facility
FDIC = Federal Deposit Insurance Corporation
FHLBB = Federal Home Loan Bank Board
FHLBS = Federal Home Loan Bank System
FRB = Federal Reserve Board
FRS = Federal Reserve System
NCUA = National Credit Union Administration
OCC = Office of the Comptroller of the Currency

Table VI-3. Structure of Depository Institution Regulation (Continued)

Mutual Savings Banks

Function	Federally Chartered FSLIC Insured	Federally Chartered FDIC Insured[d]	State Chartered FDIC Insured	State Chartered Non-FDIC Insured
Chartering	FHLBB	FHLBB	State	State
Regulation	FHLBB	FHLBB, FDIC	State	State
Examination	FHLBB	FHLBB, FDIC	State, FDIC	State
Supervision	FHLBB	FHLBB, FDIC	FDIC (State)	State
Insurance	FHLBB	FDIC	FDIC[e]	State
Liquidity	FHLBS, FRS[a]	FHLBS, FRS[a]	FRS[a], FHLBS[b]	FRS[a], FHLBS[b]

Credit Unions

Function	Federally Chartered NCUA Insured	State Chartered NCUA Insured	State Chartered Non-NCUA Insured
Chartering	NCUA	State	State
Regulation	NCUA	State (NCUA)	State
Examination	NCUA	State (NCUA)	State
Supervision	NCUA	State (NCUA)	State
Insurance	NCUA	NCUA	State/none
Liquidity	CLF[b], FRS[a]	CLF[b], FRS[a]	CLF[b], FRS[a]

[a] For institutions offering transactions accounts, as provided by Depository Institutions Deregulation and Monetary Control Act of 1980.

[b] If member.

[c] If insured by FDIC.

[d] Mutual savings banks that convert to federal charter may retain FDIC insurance.

[e] Insurance of accounts over $100,000 at FDIC-insured Massachusetts

Source: Federal Home Loan Bank Board.

have any examination duties in addition to deposit insurance, or should it rely on the several state and federal bodies that charter the banks? And should such an agency have the same set of duties with respect to all insured institutions?

Although an asymmetrical structure would be possible, the process of consolidation implies simplification and rationalization. To maintain the current differences in functions while combining the insurance agencies would be inconsistent with this goal. A consolidated agency should have the same duties with respect to all insured institutions.

The question of which duties should be lodged with the insurer, however, is more difficult to answer. There are alternative ways of organizing a new, single, government deposit insurance corporation within the regulatory structure. The merits of bringing under the same regulatory authority institutions that today are in different industries with different regulators are worth reviewing.

Some forms of organization are clearly preferable to others. Although this report is not intended to exhaust the possible alternatives, it is necessary to come to some general conclusions on what type of consolidation is contemplated before evaluating the desirability of that action.

Alternative forms of organization. In the narrowest context, the management of assets in the three insurance funds could be turned over to a new agency, while all other functions continue to reside with the insurance corporations. Alternatively, all activities--from chartering to insurance, supervision, and provision of liquidity--could be vested in a single "superagency." Along this gradient from narrow to broad reorganization are logical points of division.

At present the FSLIC and the FDIC manage their own insurance funds, while the Treasury Department manages the NCUSIF funds. The task is to decide the type, denomination, and maturity of securities to hold at any point, given income and expense projections, interest rate structure, and statutory limitations. Certain administrative duties are required to execute the purchases and sales. A new agency could be set up to handle these tasks, analogous to the role played by the Federal Home Loan Bank System in managing the sale of debt for the 12 federal home loan district banks. Section 712(a)(7) of the Garn-St Germain Act may appear to contemplate precisely that: "a study of . . . the feasibility of consolidating the three separate insurance funds" [emphasis added]. Assets of the funds could be commingled and managed jointly. Presumably, this would reduce the number of people involved in the day-to-day operations of the funds. Adding the resources of the FDIC to those of the FSLIC would also make more funds immediately available to assist problem S&Ls. Yet by splitting this function from the other insurance activities, the effort in coordination between agencies would be increased.

Neither the benefits nor the costs of this minimal reorganization would be very great. The impact of more far-reaching reforms is clearly the appropriate focus for analysis.

Apart from fund management, the agencies perform other insurance functions. These include the assessment and collection of premiums, establishment of criteria for granting and withholding insurance coverage, and taking action to protect depositors in the event of a failure. The agencies also have additional powers closely related to the maintenance of safety and soundness, but not strictly part of the insurance function. All three conduct some examination and supervision activities, although not necessarily with respect to all insured institutions. State agencies usually examine the institutions they charter. The federal deposit insurance agencies may accept the examination reports submitted by other federal or state bodies. It would be possible to consolidate fund management and other insurance functions into a single agency, while leaving intact the diffusion of supervision and examination responsibilities. Alternatively, a more comprehensive reorganization would lodge all activities bearing on safety and soundness in a single regulator. To do so, however, would entail either a shift of some state functions to the federal agency or a continuation of overlapping federal-state jurisdiction.

The agencies also play a role in setting and enforcing regulations remote from the insurance function. The purpose of such controls is to direct the structure of the industry rather than to protect depositors. Examples include restrictions on permissible lines of business, rulings on branches and mergers, and enforcement of consumer (borrower) protection legislation.

The most sweeping consolidation would incorporate liquidity functions as well. The Federal Home Loan Bank System under the FHLBB and the Central Liquidity Facility under the NCUA provide funds to member institutions at rates and on terms that may not be found elsewhere. (The FDIC has no comparable operation, but banks have access to the Federal Reserve discount window.) All depository institutions offering transactions accounts may borrow from the Federal Reserve when encountering reduced liquidity. A decision on the consolidation of the insurance agencies must necessarily address the question of how to reorganize the liquidity functions. The role of the FHLBB with respect to federally-chartered associations encompasses all of the aforementioned powers, and thus provides the best example of the superagency concept. At the other extreme, the NCUA provides only insurance to some state-chartered credit unions. In between, the FDIC has certain primary and secondary responsibilities to various classes of commercial banks. An evaluation of the arguments bearing on this question--which powers to vest in a consolidated insuring agency--follows.

Regulatory capture. One often-observed result of government regulation is that regulatory agencies eventually come to serve the interests of the industry rather than the public interest. This occurs because the agency has daily contact with firms in the industry, and measures its own success according to the health of the regulated. Restrictive regulation, propping up of inefficient firms, and restraint of competition may go unnoticed. Unfortunately, profitability can be the result of regulated prices set too high or of competitive firms excluded from the market. This identification of the regulator with the regulated is termed "regulatory capture."

Financial institutions generally have more than one regulator, which reduces the likelihood of capture. Insurance and supervisory functions are dispersed among two or more agencies in the case of most firms. Preservation of multiple levels of control is viewed as a benefit of the current structure.

Capture can only take place, however, when the regulatory agency has the ability to provide benefits and protections to the firms under its aegis. Competition from unregulated firms can reduce or eliminate these advantages. In earlier times, the FHLBB may have taken actions to shield S&Ls from market forces. Indeed, the agency's mandate includes the task of promoting the industry. But today, although the FHLBB is sole regulator for federal savings associations, it cannot raise profitability or restrict competition because of the challenges from outside the industry.

While the banks might be brought under common regulatory control in a new organizational plan, myriad securities brokers, mutual funds, and others would still be able to compete unfettered. A superagency might have a monopoly on the granting of deposit insurance, but the success of uninsured money market mutual funds demonstrates the limits of even that advantage.

Gaps, overlap, and duplication. Two or more agencies share responsibility for the safety and soundness of most depository institutions. Often the insurance and examination functions are performed by separate federal agencies. This division of duties can lead to problems because no single agency is ultimately in charge.

Gaps in regulation can occur if neither agency involved asserts sufficient control. Regulation is then ineffective. This situation may arise because of a lack of accountability or because each agency individually is too small to control a large financial institution effectively. For example, in a recent case involving a holding company with both banking and thrift interests, it has been asserted that problem assets eluded regulatory detection because the loans were switched among institutions between audit dates. Only a special plan involving simultaneous examinations by the different regulators managed to uncover the problems. Consolidation of the functions of the multiple agencies would create a single, larger regulator. That agency would be better able to assert control, would be more likely to be held accountable in the event of problems, and would be a centralized focus for Congressional oversight.

When two or more agencies operate under different interpretations of the law, the resulting overlap leads to delay and regulatory cost burdens on both firms and agencies. One of the most serious conflicts occurred during the mid-1960s between the Office of the Comptroller of the Currency and the other federal regulators. The Comptroller had ruled that national banks could enter a number of new lines of business under that part of the Banking Act providing for "incidental powers." Among the newly authorized functions were corporate savings deposits, purchase of corporate stock, and the underwriting of municipal revenue bonds. The Comptroller also permitted banks to use accounting definitions that effectively relaxed certain loan and capital restrictions. The Federal Reserve, which also has authority over national banks, objected, and a series of legal battles followed. As part of the dispute, the Comptroller demanded a fee from the FDIC for supplying examination reports. Because the FDIC refused to pay, it could not obtain the reports, which may have impaired the insurance agency's ability to address in timely fashion the problems of at least one institution--the San Francisco National Bank (Hackley 1966). This disagreement persisted for several years.

Other issues have been resolved more quickly, but often by virtue of the size and prestige of the larger agency involved and not for substantive reasons. There was much uncertainty among national banks as to what activities were legal, and state-chartered banks believed they were treated unfairly. Obviously, such discrepancies would not have occurred had there been but one agency in charge.

Some needless costs may be incurred even if the two agencies with common jurisdiction apply consistent rules. Extra administrative costs are borne by the firms and the agencies if certain regulatory and examination activities are duplicated.

In practice, the major administrative cost of regulation (for both the agency and the firm involved) is incurred as a result of examinations. Most agencies have worked out arrangements to avoid duplicate or inconsistent examinations. The Comptroller, the Federal Reserve, and the FDIC have divided the responsibilities among themselves for federally insured banks. The Federal Reserve and the FDIC have, in turn, arranged with many states to alternate examinations of state-chartered banks and accept each other's reports. For its part, the Office of Examination and Supervision in the FHLBB conducts examinations for both regulatory and insurance purposes and has a program of joint examinations with state agencies. Thus, the extent of duplication is probably small.

The potential future problems associated with gaps and overlaps in regulation remain. The savings and loan regulatory structure is concentrated in the FHLBB and therefore avoids such problems. Yet it may be possible to minimize the likelihood of their occurrence while maintaining multiple agencies. Several attempts have been made to coordinate the activities of the federal regulators. The Interagency Coordinating Committee on Bank Regulation, formed in 1965, tried to resolve the sorts of problems encountered between the Comptroller and other agencies. More recently, the Federal Financial Institutions Examination Council has sought the same goals. The difficulty has been tuat each agency is independent. Each feels bound to assert its statutory authority and responsibility. Statutory change, whether involving consolidation of the agencies or merely a redefinition of powers, seems to be indicated.

Coordination of assistance operations. When a depository institution is in danger of failing, the deposit insurance agency plays a major role. Measures to forestall the failure can often protect insured depositors and preserve the firm at lower cost than liquidation and payout.

Many tools are available to tailor a support operation to the characteristics of the situation. Regulatory agencies can provide loans or direct grants, arrange a merger, sell assets or facilities, or purchase capital notes as alternatives to liquidation of the firm. The FSLIC, as part of the FHLBB, and the NCUA have access to all of these powers, whereas the FDIC has fewer choices at its command; some of the authorities pertaining to bank assistance reside with the Comptroller or the Federal Reserve. For example, the FDIC has no say in the closing of insured banks. That is the responsibility of the chartering authority (Comptroller or state agency). Of course, the FDIC may revoke insurance coverage, but that is an unwieldy tool that can be used only with appropriate notice and substantial delay.

The most efficient approach to a problem situation may involve the application of several measures simultaneously. Coordination of the techniques employed is a necessity. Achieving this consistency in assistance cases is more difficult when multiple agencies are involved.

Division of responsibility for bank regulation can impede the resolution of bank problems (U.S. General Accounting Office 1977; Varvel 1976). The Comptroller can arrange mergers for national banks, the Federal Reserve provides a liquidity facility, and the FDIC has certain assistance powers. But all of the agencies involved must agree on the need for and the proper course of assistance.

The various agencies have different criteria for identifying problem banks. This results in ambiguous signals being sent to the firm and to the regulators involved. Remedial action may be delayed because of divergent views among the agencies. A regulator may be reluctant to act unilaterally because that could induce banks to change their charters in search of a less stringent agency. Even if prompt steps are taken, the coordination among agencies requires time and effort, which are costly. A major difficulty is that the three principal federal bank regulators have different goals: the Comptroller's major interest is maintenance of the banking system; the Federal Reserve is primarily concerned with the soundness of the economy and the stability of the money supply; and the FDIC's objective is preservation of the insurance fund. Because these goals are not necessarily consistent, conflicts among the agencies may arise.

Two examples illustrate the potential for problems. The San Francisco National Bank encountered severe financial difficulties during 1964. Although the Comptroller was aware of the bank's condition and took steps to remedy the problems, that agency did not inform the Federal Reserve System or the FDIC of what it had found (U.S. Congress 1966). Although the bank was placed in receivership the next year, substantial delay occurred, which may have increased the costs of resolving the problems. A Congressional subcommittee (U.S. Congress 1966, 9) concluded, "This is a clear illustration of the breakdown of liaison and lack of cooperation among the banking agencies."

In 1974, Franklin National Bank in New York suffered losses on investments that threatened its continued existence. The Comptroller had the authority to close the bank, but sought a merger partner instead. While this search took place, uninsured depositors started a run on the bank, which required substantial advances from the Federal Reserve System. Because there was insufficient collateral for these advances, the FDIC was asked to guarantee them. This the agency was reluctant to do without assurances from the Comptroller that the problem would be resolved quickly. Coordination was eventually achieved, but it evidently took too long. Delays of this sort in future cases might increase the eventual costs of assistance. Delay may be the major cost of coordinating action among independent agencies. Necessary measures are postponed until the problems become difficult to correct.

The unified structure of the FHLBB is therefore the preferred form of organization for handling failing firms. Regulatory, supervisory, examination, and liquidity functions are under the same authority as insurance. The combination of these powers gives the FHLBB the ability and incentive to handle assistance cases expeditiously and efficiently. The FHLBB has all of the necessary tools, it suffers all of the costs, and it garners all of the benefits of its actions. Accountability is concentrated; because the responsibility cannot be shifted, the agency has an incentive to achieve the best balance among competing goals.

A contrary view holds that coordination among independent agencies is sufficient, that consolidation of functions is not required. Other reasons may account for the delay in resolving bank problem cases, including the maintenance of public confidence and the desire to minimize government interference. Bank failures in any event have been relatively infrequent and not very costly. And it is difficult to identify agency structure as a contributing factor in any bank failure.

The merits of FHLBB's form of organization have been demonstrated, but the weaknesses in bank regulation are more conjectural. On balance, there is a sound but not decisive case favoring a unified agency structure to deal with the problems of failing depository institutions.

Competing objectives. Regulatory agencies have other duties besides the resolution of problem cases. The appropriate agency structure remains an issue when these other tasks are considered, because the question of reconciling competing objectives is inherent to the supervisory process. On the one hand, the agencies want to promote safety and soundness. But they are also charged with maintaining competition, fostering innovation, and meeting the needs of the community. These activities imply risk-taking and the possibility of failure.

In the case of bank regulation, the FDIC exerts a conservative influence while the chartering authority (Comptroller or state) encourages development and growth. There is no uncertainty on the part of either agency as to its role, but there is continuing tension as they pursue different ends. Because the bank chartering authority is independent of the FDIC, it need not accede to the insurance agency's concerns about risky behavior on the part of banks. Similarly, the chartering authority has no recourse if the FDIC uses its insurance regulations to restrict bank activity unduly. There is no reason to expect that the balance achieved in this manner is correct.

For the FHLBB and the NCUA, the debate is entirely internal. A decision is made on the desired tradeoff between safety and competition, and all policies are set to attain that objective. Any errors or deviations can be quickly detected and policies adjusted accordingly. It seems more appropriate to internalize thus the costs of regulatory decisions. If the decisions of a unified agency are incompatible with overall government policy, they can be easily corrected. Implementing policy is more difficult when instructions must be given separately to two or more agencies, each of which will react to the others' shifts in rules and procedures.

This discussion is predicated on the present insurance system's operations, in which the deposit insurance corporation has only limited means of influencing the risk-taking behavior of member firms; hence the need for consolidation or coordination with the agencies having the remaining controls. Elsewhere, however, this report has proposed modifications to make the price of insurance more sensitive to risk. This approach is an alternative to regulation for internalizing the costs and benefits of business decisions. Under a fully risk-sensitive plan, with the ability to adjust premiums to any set of bank or thrift practices, the insurance function could be completely isolated from all other regulatory activities and still operate effectively.

Competition Among Regulators

The previous discussion explored alternative ways of organizing a regulatory agency for financial institutions, arguing that supervisory and liquidity functions should accompany the insurance function. Analyzed here is whether the proposed agency should have authority over all insured depository institutions in contrast to the current system of multiple agencies.

Today a depository institution may choose among several different types of charter. With each goes a different primary regulator, as well as a choice of insurer. Now that the distinctions between banks and thrifts have been lessened, the options are even wider. In addition to the long-standing alternatives among the three federal bank regulators, a commercial bank might now seek to operate as a federal savings bank under the FHLBB. Presumably, if one regulatory body is more stringent, less innovative, or more cumbersome than the others, firms under its jurisdiction will seek to change their charters and new firms will not choose to organize under that regulator. Thus the agencies compete to retain their jurisdiction by offering operating conditions that are most attractive from the point of view of the firms. This is called "competition in laxity" (Silverberg 1976). Much debate has surrounded the issue, with two major points of contention: first, does this "competition" in fact take place to a significant extent or are regulators constrained by statute and their own sense of proper controls? Second, is this competition desirable, in that it fosters innovation and promotes allocative efficiency, or is it harmful because it permits unsound practices that impose costs on society? The evidence is mixed on both issues.

Competition among the regulators is thought to take place along several dimensions. Regulators may disagree about the most desirable market structure for financial institutions. Their decisions may therefore differ on proposed mergers, branches, or holding companies. Conceivably, an institution could arrange a transaction so as to come under the jurisdiction of the more lenient regulator. A national bank may choose to structure a consolidation as a merger rather than as a holding company acquisition if it believes that the Comptroller would be more likely to approve the transaction than the Federal Reserve. Other instances of this activity are not difficult to find. The recent acquisition of a state bank by a securities firm, on which the FDIC and Federal Reserve have sharply divergent views, is a case in point. But it is less clear that the action is a result of competition in laxity. The transaction is presumably in the interest of the parties involved, yet rival firms under the same regulator may now face keener competition, so this is hardly an unambiguous example of pro-industry behavior.

Examination is the heart of the supervisory process and the manner in which the agencies most directly affect the operations of individual firms. However, no regulator is likely to condone violations of law as a way of accommodating regulated banks or thrifts. The inevitable failures and lawsuits that would result would be attributed to supervisory incompetence. Indeed, regulators will always be judged on the success of their decisions--an important check on excessive laxity.

Over the years, new authorities have been granted to banks and thrifts through statutory changes and also through new interpretations of existing law. It is in the granting of asset, liability, and service powers that regulators have had the greatest scope. In the 1960s, the Comptroller took a more liberal view of banking law than other federal regulators. A number of banks, including the Chase Manhattan Bank, switched to national bank charters to take advantage of the new powers. State-chartered thrift institutions in New England developed and were allowed to offer negotiable order of withdrawal (NOW) accounts in the early 1970s, while a federal prohibition on the practice remained in effect. This permitted the testing of an innovation in a limited market to demonstrate its feasibility--a practice that probably would not have been possible with a single national regulator. A third example is found in the real estate lending powers of commercial banks. National banks were restricted in this area, although many state statutes were silent, permitting state banks to experiment. When the practice proved viable, national banks received many of the same powers.

Innovation can originate with the regulator. The interests and needs of different types of institutions may call for specialized programs. Agencies adapt and innovate to accommodate these needs. The FHLBB, for example, was motivated to develop income capital certificates, phoenix associations, and interim associations to address the problems of S&Ls. The FDIC, because commercial banks are its principal concern, did not develop any special programs for the mutual savings banks whose deposits it insures. On the other hand, the FDIC has been able to deal with problem cases using existing tools.

So the question recurs on the importance and desirability of competition in laxity. The numerous changes of charter may be evidence of a flight to leniency, but other explanations are possible. Many banks and thrifts have chosen federal charters even when state regulation is more congenial, because dealing with a single regulator can be simpler. In any case, the number of changes has been small relative to the size of the industry, and many institutions remain in each category, even with the diversity in regulatory stringency and the relative ease of changing charter.

A strong case can be made that incentives for regulators to safeguard the public interest outweigh any inclination toward laxity. Indeed, one possible interpretation of competition in laxity is that regulators are deviating from the intended public policy for reasons of their own. And they may do so independent of what other regulators offer.

Innovation is motivated by market forces, not laxity. Firms will continue to develop new products and services regardless of regulatory restrictions. The history of financial regulation has shown that consumer demand eventually leads to regulatory acceptance of desirable innovations.

The savings and loan industry may be a useful counterexample to the laxity notion. Although it is under the control of a single federal agency, it has been as progressive as the banking sector. Decentralized review of merger applications, permissive funds transfer regulations, and a program for long-term advances have all arisen under the monolithic savings and loan structure.

Regulatory competition is severely limited as a force for innovation and efficiency. A single coherent policy toward financial institutions is needed. It is inappropriate and inequitable to have agencies applying different criteria to otherwise similar firms. If the policy proves to be too rigid, then Congress or the Administration can propose changes in the governing statutes or seek modifications in regulatory practice through the oversight and appointment processes. That is the major case against regulatory laxity. Although the process can lead to unsound practices, this does not seem to have happened often enough to warrant cancern.

Moreover, the new regulatory environment reduces the importance of the agency in controlling the development of the industry. Statutory limitations are now less stringent, and thus leave fewer decisions in the realm of the agency. Fewer distinctions between the banking and thrift industries exist, minimizing the potential differences in regulatory practice. Perhaps most important, a large and highly developed unregulated financial sector exists to provide a competitive check on excessive regulatory stringency. The virtual elimination of savings rate ceilings with the inception of the money market deposit accaunt is the direct result of the success of money market mutual funds.

Any advantages of competitive laxity are minor. Ambiguity in the execution of government policy is a major cost. Competition in laxity argues in favor of a single agency to regulate all financial institutions.

Cost Savings from Consolidation

Two areas of potential cost savings may be examined. First, the administrative functions of the agencies may operate more efficiently combined than separated. That would be true if there exist economies of increasing scale. Second, a consolidation of the insurance corporations would also imply a common insurance fund. The combined fund may not require as large a reserve as the three independent funds if scale economies exist, permitting a reduction in premiums.

Overhead expense. One of the initially appealing rationales for regulatory consolidation is reduction of agency administrative expenses. With three insurance agencies, a number of functions undoubtedly are needlessly duplicated. As will be shown, however, the potential savings are relatively small. While consolidation may indeed be desirable, reduction of government costs should not be used as a reason for doing so. That decision must rest on a broader determination of what type of regulatory structure will permit the financial sector to operate most efficiently.

The largest expenses associated with deposit insurance are the payments made to weak institutions and to depositors of failed institutions. In 1981, more than 85 percent of combined FHLBB-FSLIC expenses went for this purpose (FHLBB 1982). For the FDIC, the figure was also 85 percent (FDIC 1982); for the NCUSIF, 82 percent (NCUSIF 1982). Estimates for 1982 are comparable. These expenditures are a function of the operating performance of insured firms and would not be affected by the consolidation of the agencies.

Most remaining expenses are administrative costs related to the examination of insured institutions. Examinations for the FSLIC are conducted by the Office of Examination and Supervision of the FHLBB; that single function accounted for more than 60 percent of the remaining (administrative) expenses. The same number of institutions would still be examined after consolidation, so no savings would be possible in that area. All other costs of operating FSLIC in 1982 totalled $40.6 million. FDIC administrative expenses were $129.9 million, a figure that includes the cost of examining state banks that are not members of the Federal Reserve System. Administrative expenses for the NCUSIF were $10.5 million.

These figures are small compared with total premiums collected and miniscule in comparison with deposits (as shown in Table VI-4). As a demonstration of the impact of reduced expenses, an upper bound for potential savings can be assumed equal to the current costs of operating the FDIC alone. Actual savings, of course, would be substantially less. The hypothetical cost reduction would equal the $40.6 million expenses of the FSLIC plus the $10.5 million expenses of the NCUSIF, or $51.1 million. This would represent only 0.002 percent of deposits (two-tenths of one basis point). By comparison, gross premium collections are 0.083 percent of deposits, so the savings would not exceed 3.0 percent

Table VI-4. Operational Characteristics of the Agencies, 1982
(Dollar Amounts in Millions)

Agency	Operating Expenses	Net Premiums Collected	Deposits at Insured Institutions (End of Year)
FSLIC	$ 40.6	$ 427.0	$ 527,512
FDIC	129.9	1,012.7	1,442,329
NCUSIF	10.5	75.4[a]	64,264
Total	181.0	1,515.1	2,044,105

[a] Includes $29.9 million from a special premium set at 1/18 of 1 percent of deposits.

Sources: Federal Home Loan Bank Board. 1981 Annual Report. Washington, D.C.: Government Printing Office, 1981: table 3; Federal Home Loan Bank Board. Unpublished Data, 1983; Federal Deposit Insurance Corporation. 1981 Annual Report. Washington, D.C.: Government Printing Office, 1982:table 129; Federal Deposit Insurance Corporation. Unpublished Data, 1983; National Credit Union Share Insurance Fund. Annual Financial Report, Fiscal Year 1981. Washington, D.C.: Government Printing Office, 1982:26; National Credit Union Share Insurance Fund. Unpublished Data, 1983.

of the gross premium (3.4 percent of net premiums) and would probably be even smaller. At less than one-half of one basis point (before tax), the reduction in operating costs would have no measurable effect on returns to depositors, borrowing costs, or industry profitability.

Size of the fund. When a resource is subject to random demands, the principle of economies of massed reserves may apply. Size offers advantages in maintaining capacity sufficient to meet fluctuations in demand, because the more firms that are served, the more likely it is that random claims will occur at a steady predictable rate. Although this principle applies to manufacturing firms, its usefulness in cash management applications is not proven.

Earlier this report has discussed the appropriate size of the insurance fund. Those conclusions are also relevant here. The size of the insurance funds heretofore has not been determined actuarially. In the event a fund is exhausted, there is an implicit federal promise to make good on the obligations. Therefore, no basis exists for assuming that a consolidated fund should bear a lower (or higher) relationship to deposits than the funds do separately.

The recent problems of the thrift industry have raised this question in another context. Because the FDIC insures accounts at relatively few troubled institutions--in contrast to the substantial burden on the FSLIC--some have suggested consolidation of the funds as a way of enlarging the pool of resources available for problem S&Ls without tapping the Treasury. However, as funds would necessarily be expended to protect insured deposits in any event, the economic impact is unaffected by the agency structure under which assistance is provided. The issue of consolidation should be decided on the basis of long-range substantive concerns and not on short-range procedural expedients.

Cross-Industry Transactions

For most of the past 50 years, the financial system has been characterized by rigid separation of the industries. The banking and thrift sectors were distinct; regulation of each could proceed independent of the other. Beginning in the mid-1960s, however, and to an increasing extent in recent years, interrelationships have been established.

Banks and thrift institutions are now much more alike as each industry has been granted authorities formerly the exclusive preserve of the other; over time, remaining differences will diminish. There has been a marked change in the relative health of banks and thrifts. And all depository institutions, whatever their past successes, must meet the challenges presented by unregulated firms, innovation, and economic and demographic shifts. More than ever before, coordinated regulation for S&Ls, mutual savings banks, and commercial banks is needed.

Mergers and acquisitions. The combination of a bank with a thrift institution, or an S&L with a mutual savings bank, requires approvals from multiple regulatory authorities. Such transactions are likely to become increasingly common. The delay inherent in seeking the necessary clearances can be costly to the firms involved. Perhaps more important, current procedures can impose major costs on society and the insurance agencies if the resolution of a potential failure is jeopardized. When different agencies are involved, disagreements will be inevitable, whereas sound policy requires that the federal government speak with one voice on such issues. The necessary coordination will be difficult to achieve without rationalization of the regulatory structure.

Change of charter. To take advantage of the new powers accorded federal thrift institutions, a mutual savings bank must change to a federal savings bank charter. That would normally imply a transfer of deposit insurance from the FDIC to the FSLIC. But that switch could be inequitable without financial compensation. The savings bank would have paid premiums to the FDIC during the period required to assemble its portfolio, yet any assistance costs necessitated by the maturity imbalance of those earlier investment decisions would fall on the FSLIC. The potential liability, however, would be difficult to calculate. This problem forestalled federal chartering between 1980, when the first new powers were granted, and 1982, when a temporary solution was arranged. Now, federal savings banks can continue their FDIC insurance until accepted for insurance by the FSLIC. As a long-term policy, this is clearly unacceptable, and it is a problem neatly avoided through agency consolidation.

Multi-industry activities. With the new asset powers granted in 1982, thrift institutions will begin investing in areas traditionally the realm of commercial banks. To take advantage of the expertise of the banks, many thrifts may choose initially to enter commercial lending by participating in loans originated by the banks. Regulations for the banks and thrifts must be consistent to permit these transactions. Equally important, the insurance regulations must impose the same incentives on both parties to avoid an adverse selection problem (the riskier part of the loan shifted to the institution with the less risk-sensitive insurance). One alternative is for the FSLIC and the FDIC to develop new insurance regulations in concert. Agency consolidation has obvious advantages in this area.

Coordination vs. consolidation. Coordination will become increasingly difficult as the financial services industries evolve toward one another. The areas of interaction will be numerous. Furthermore, any rationale that may once have argued for specialized regulators is diminished as the distinctions are eliminated. This argues for moving toward a consolidated agency as industry structures converge.

The activities of financial institution holding companies will be a focus of concern in the future. Bank holding companies are regulated by the Federal Reserve Board and are constrained with respect to nonfinancial endeavors. Savings and loan holding companies are regulated by the Federal Home Loan Bank Board and, if they control only a single S&L, can engage relatively freely in many nonfinancial activities. Moreover, the prospect of widespread interstate branching for S&Ls would permit a holding company to expand while retaining the advantage of single-association status. As savings institutions acquire more bank-like powers, competitive equity will demand equal treatment of all holding companies.

Risk Differences Among Insured Institutions

The particular history of depository institutions has made each set of institutions especially vulnerable to a different type of risk. Is it possible to design a single insurance system to deal equitably with all institutions under a consolidated agency? Expansion of portfolio powers will permit some convergence, but the nature of the institutions indicates that some distinctions will persist. The long-run issue of balanced treatment is reviewed here, followed by a discussion of transition problems.

The exposure of the traditional thrift portfolio to interest rate risk is well known. New asset powers, including alternative mortgage instruments, can ameliorate this problem. Yet thrift institutions will remain subject to interest rate swings for many years, and they may even choose to continue long-term portfolio lending. Banks are unlikely ever to become as sensitive to rates, but they do have their own problems associated with credit risk. Another difference is that private capital provides a larger buffer for the banks' insurance fund than in the thrift industry, while a smaller share of total deposits are covered by federal deposit insurance. The credit unions are not affected by interest rates as much as the savings institutions, because their portfolios are more closely matched. In addition, because they lend to members whose earnings and credit histories are well known, the exposure to default risk is less likely than for banks. But credit unions are the smallest of the depository institutions, and their managements may be inexperienced, serve only part-time, and be called on to undertake diverse tasks. The possibility of mistakes or sub-par performance (management risk) is perhaps the greatest concern for the credit union industry.

These important differences could hamper the development of a unified insurance system. Yet to a large degree, the problems exist already. The savings and loan industry is divided between stock and mutual associations. The FDIC must apply common rules to commercial banks and mutual savings banks. Conflicts have already arisen along these lines. Consolidation would not affect the need to deal with such issues in the context of deposit insurance reform. The task is to design a system that considers the functions being performed rather than the industry designation of the firm involved. This may result in different treatment for institutions now treated alike, but to the extent that this reflects their varying activities, it will be appropriate to do so.

Transition Issues

The thrift, credit union, and banking sectors developed separately, with specialized regulators. Both firms and agencies today look quite different, as is illustrated in Table VI-5. Although the variation will fade with time as institutions exercise their increased flexibility, the existing structure of the firms and the practices of the agencies may initially be difficult to reconcile.

The relatively weaker condition of the thrift industry may be the most difficult issue. Commercial banks have already had to pay higher net premiums to the FDIC to cover the cost of assisting mutual savings banks. Even if the most difficult period has passed, thrifts will receive more in assistance than they pay in premiums for the next few years. That does not necessarily imply that commercial banks would be subsidizing the thrifts. The current rule for determining FDIC assessment credits could be modified if it were deemed appropriate to do so. Consolidation of the insurance funds does not change the situation. Who should pay the

Table VI-5. Coverage of the Agencies, June 30, 1982

	FSLIC	FDIC		NCUSIF
	Savings & Loan Associations	Commercial Banks	Mutual Savings Banks	Credit Unions
Assets (billions)	$ 680	$ 1,738	$ 157	$ 71
Deposits (billions)	$ 528	$ 1,803	$ 140	$ 64
Number of Firms	3,573	14,435	325	16,802

Sources: Federal Home Loan Bank Board. 1981 Annual Report. Washington, D.C.: Government Printing Office, 1982: table 3; Federal Home Loan Bank Board. "Savings and Loan Activity in December." Photocopy, January 28, 1983: tables 3,5; Federal Home Loan Bank Board. Unpublished Data, 1983; Federal Deposit Insurance Corporation. 1981 Annual Report. Washington, D.C.: Government Printing Office, 1982: table 129; Federal Deposit Insurance Corporation. Unpublished Data, 1983; National Credit Union Share Insurance Fund. Annual Financial Report, Fiscal Year 1981. Washington, D.C.: Government Printing office, 1982:26; National Credit Union Share Insurance Fund. Unpublished Data, 1983; National Credit Union Administration. Unpublished Data, 1983.

costs of assistance for a systematic problem affecting an entire sector is an issue of income distribution, not regulatory structure. Some would argue that the stronger firms are best able to pay, while others would maintain that each industry should be responsible for its own members.

The agencies themselves show evidence of independent evolution. Each is appropriately concerned with the particular industry under its jurisdiction. The concern is that a merger of two of the existing funds into the third may lead to a bias in favor of the traditional membership of the surviving agency. Decisions could be made in ways that favor banks over thrifts, stock institutions over mutual firms, federal over state charters, large over small. That potential exists even today: the FDIC insures the largest financial institutions, but its average member is smaller than the average FSLIC-insured savings and loan association; both the FDIC and the FSLIC insure stock and mutual, large and small, federal and state.

The agencies also approach the problem of failing institutions in markedly different ways. Table VI-6 shows the number of assistance cases by type for each agency over the past 12 years. The FSLIC relies almost exclusively on assisted and supervisory mergers, because it has found that practice less costly than liquidation. The relatively small size of the FSLIC fund has been a bargaining point in negotiating the amounts of assistance to be

Table VI-6. Number of Firms Assisted, 1970-1982

	FSLIC		FDIC		NCUSIF	
Year	Merger	Liquidation	Merger	Liquidation	Merger	Liquidation
1970	10	0	3	4	...	...
1971	5	1	1	5	32	0
1972	2	0	0	1	54	4
1973	4	0	3	3	54	50
1974	1	0	4	0	76	100
1975	2	0	10	3	196	153
1976	6	0	13	3	198	128
1977	1	0	6	0	191	142
1978	1	0	6	1	196	168
1979	2	0	7	3	193	169
1980	11	0	7	3	313	239
1981	30	1	8	2	333	251
1982	17	1	35	7	653	112

Sources: Federal Home Loan Bank Board. 1981 Annual Report. Washington, D.C.: Government Printing Office, 1983: table 3; Federal Home Loan Bank Board. Unpublished Data, 1983; Federal Deposit Insurance Corporation. 1981 Annual Report. Washington, D.C.: Government Printing Office, 1982:table 129; Federal Deposit Insurance Corporation. Unpublished Data, 1983; National Credit Union Share Insurance Fund. Annual Financial Report, Fiscal Year 1981. Washington, D.C.: Government Printing office, 1982:26; National Credit Union Share Insurance Fund. Unpublished Data, 1983.

provided. The FDIC has traditionally taken upon itself the task of liquidating the assets of failed firms. The cash drain on the FDIC fund has therefore been relatively larger than on the FSLIC fund. The NCUSIF uses both liquidation and merger, depending on individual circumstances. The surviving agency in a consolidation might be inclined to persist with its traditional practice--a course of action that could be detrimental to some of the covered institutions or to the preservation of the insurance fund.

In evaluating the merits of these arguments against consolidation, it is important to differentiate between the process of rationalization itself and the merits of combining into one of the existing agencies. Disagreement with the current policies of the FSLIC, FDIC, or NCUSIF does not imply flaws in the concept of consolidation. Practices and personnel can be changed, if necessary, to carry out the mandate of the insurance system. If a major reorganization of the regulatory and supervisory structure is anticipated, the needed reforms in insurance practice can be incorporated in the process of change.

REFORM PROPOSALS

Proposals for overall reform of the financial regulatory structure of regulation have been made since virtually the moment the original legislation was enacted. Even before the establishment of the FDIC (the first federal insurance agency), legislative proposals were advanced to consolidate the functions of the then-existing bank regulatory agencies. Between 1919 [illegible] 1921, four separate bills were introduced in Congress to abolish the Comptroller of the Currency and to transfer its examination and supervision powers to the Federal Reserve.

Brookings Study (1937)

In 1937 the Brookings Institution completed a comprehensive study of the federal bureaucracy under contract for a Senate committee. The report recommended that the Office of the Comptroller of the Currency be abolished, and that the FDIC be put in charge of chartering national banks, subject to Federal Reserve Board approval (U.S. Congress 1937). The FDIC was to be accorded veto power over the admission of any state bank to the Federal Reserve System, as well as the authority to examine all insured banks. The Federal Reserve Board would have been allowed to continue examining Federal Reserve banks and to make supplementary examinations when necessary of member banks and those applying to the Federal Reserve System. This plan would have made the FDIC the principal agent in the examination process, resolving ambiguities in the original legislation over the examination of member banks and eliminating inefficient duplication of efforts. The reforms were intended to strengthen the FDIC by giving it more power to control the granting of insurance and to investigate the solvency of a bank. Because of its financial stake in the process, the FDIC was regarded as placing more importance on these activities than the Federal Reserve Board.

The Office of the Comptroller of the Currencey was the agency chosen for abolition because, of the three agencies, it was regarded as the one with duties most easily transferred. The report stated that further consolidation of regulatory functions into one agency would impair the role of the states in regulating banks, a reform proposal beyond the scope of the study as it involved political and economic issues rather than considerations of administrative efficiency.

Legislative Proposals (1938-1939)

During the next two years, bills were introduced to move the supervisory functions of the Federal Reserve to the Comptroller, creating a new single agency called the Federal Bureau of Examination and Supervision. The FDIC was to be transferred to a Federal Bureau of Insurance within the Treasury Department. Other bills were advanced to consolidate the Comptroller entirely into the FDIC and to transfer the functions of the Federal Reserve to the FDIC.

The Hoover Commission (1949)

In 1949, three new reform proposals were recommended by separate task forces set up under the Commission on Organization of the Executive Branch of the Government, commonly referred to as the Hoover Commission. One transferred the FDIC to the Federal Reserve Board, the second moved the Comptroller to the Federal Reserve Board, and the third recommended that all federal banking agencies be consolidated under the Federal Reserve Board. The Commission itself rejected all of these suggestions in favor of a fourth--transferring the FDIC to the Treasury Department.

Reorganization Plan No. 2 (1956)

Submitted by President Dwight D. Eisenhower in accordance with the Reorganization Act of 1949, as amended on May 17, 1956, this plan would have provided the FSLIC with its own management, separate from the FHLBB (U.S. Congress 1956). The fund would have been directed by a three-member board of trustees composed of two Presidential appointees and the chairman of the FHLBB, ex officio. The activities accorded the FSLIC board would have included the management of the FSLIC and the supervision and regulation of insured institutions. The FHLBB was to retain the power to supervise and regulate the federal home loan banks, as well as the power to charter, supervise, and regulate federal S&Ls.

In his message to Congress accompanying the plan, President Eisenhower cited two reports, one by the General Accounting Office and the other by the Second Commission on Organization of the

Executive Branch of the Government. The studies argued that the functions of promoting and chartering federal S&Ls conflicted with the function of administering the insurance underwriting; therefore, the two agencies should be separated. The President also noted that the chairman of the FHLBB was to sit on the board of trustees in order to facilitate coordination of FHLBB and FSLIC policies, paralleling the structure of commercial bank regulations. The plan was rejected by both the House and the Senate, on the grounds that further study should be made before taking action of such major consequence. The House report not only noted the large sums of money involved as reason for exercising caution in effecting structural change, but also recognized that recent evidence of laxity in examinations indicated the need to address the issue.

During the hearings, several points were raised to counter the case for separation. Underlying the conflict-of-interest argument was a theory outlined by the Bureau of the Budget suggesting that the FHLBB would tend to grant charters to risky savings and loan associations that could result in heightened risk exposure for the FSLIC. The staff report of the Senate Subcommittee on Housing argued that a separation of the two organizations along the Comptroller-Federal Reserve Board-FDIC model would only exacerbate the situation unless the FSLIC were granted power to refuse to insure an association. The argument made against such a separation arrangement, allowing the FSLIC to deny insurance, was that it would result in disagreement over approval criteria, creating unnecessary conflict and delay. In essence, it would produce a confusing reversal of the line of power, with the FSLIC able to negate FHLBB actions. According to the staff report, the optimal structure was the current one, in which the FSLIC has veto power in the granting of charters by the FHLBB if it believes the S&L poses undue risk to the corporation.

Commission on Money and Credit (1961)

The next major reform proposal came from the report of the Commission on Money and Credit in 1961. The report recommended that the examination and supervision functions of the FDIC and the Comptroller be transferred to the Federal Reserve System and that deposits in mutual savings banks be insured by the FSLIC. The commission intended to eliminate the problems of coordination and duplication resulting from the informal arrangements developed by the agencies to fulfill their respective legislative mandates.

H.R. 729 and 4253 (1963)

The first proposal to consolidate the FSLIC and the FDIC was introduced in 1963. The House bill (H.R. 729) would have established a Federal Deposit and Savings Insurance Board in charge of managing both insurance funds. Other functions--chartering, regulating, examining, and supervising banks and thrift institutions--were not to be affected by the change except that the new agency would also be in charge of examining and supervising state nonmember S&Ls. The FHLBB argued, however, that the proposal would increase inefficiency by splitting federal activities relating to savings and loan associations between two agencies (U.S. Congress 1963). Also, the new agency would be rendered less effective in general because it would be forced to develop expertise in dissimilar fields--the banking and thrift sectors.

H.R. 4253, introduced concurrently, did propose consolidation of the chartering, regulatory, and supervisory powers then accorded to the Comptroller, the Federal Reserve Board, and the FDIC into a single new agency. The FHLBB favored the bill because it believed that the fragmentation of functions in the existing system made for inefficiency. But the FHLBB's stand was moderated by what it regarded as a history of relatively successful coordination among the three banking regulatory agencies.

Senate Investigation into Federally Insured Banks (1965)

A few years later, the question of regulatory consolidation in the banking field was again raised in extensive hearings conducted by the Senate Committee on Government Operations. The problems of interagency coordination and communication were brought up in the testimonies of representatives of the FHLBB, the FDIC, and the

Federal Reserve System. The chairman of the FHLBB noted the difficulties experienced by the FHLBB in securing the cooperation of state authorities to impose corrective measures on state-chartered associations engaged in illegal or improper practices (U.S. Congress 1966, 193). The chairman of the FDIC testified that until two years previous, the office of the Comptroller had consulted with both the Federal Reserve System and the FDIC concerning the approval of charters, even though it was under no legal obligation to do so (U.S. Congress 1966, 159). He also reported "differences in opinion" that had interfered for approximately a year in the agencies' liaison for bank examination. However, he did not endorse the idea that the three banking regulatory agencies should pool their examination activities. In spite of the communication difficulties he had described, the FDIC chairman testified that the current system worked well enough and that no change was warranted.

The chairman of the FHLBB also did not recommend structural reform, but the Federal Reserve Board chairman was more favorable to the notion, recommending a comprehensive study on the consolidation of the supervisory functions at the federal level (U.S. Congress 1966, 241). This opinion was echoed by the subcommittee members, who included the consolidation of examination functions in the scope of the study.

The Hunt Commission (1971)

In 1971, one of the most famous studies on regulatory reform was conducted by the President's Commission on Financial Structure and Regulation (1971), more commonly known as the Hunt Commission. In its report, the commission recommended the establishment of a Federal Deposit Guarantee Administration, incorporating FDIC, FSLIC, and NCUSIF, but retaining the separation of their funds. The trustees in charge of governing the new body were to include a director and four members: the chairman of the FHLBB and the administrators of the National Credit Union Administration, the National Banks Administration, and the State Banks Administration. The National Banks Administration, a new organization separate from the Treasury, was to replace the Office of the Comptroller of the Currency and to take on the chartering, examination, and supervision of federally chartered mutual savings banks. The State Banks Administration, another new agency, would assume the Federal Reserve Board's regulatory, examining, and supervisory responsibilities toward state-chartered, federally insured commercial and mutual savings banks. The regulatory and supervisory functions of the FDIC, except those relating to the determination and collection of insurance premiums, were to be transferred to the State Banks Administration. Each regulatory agency was granted the right to receive the examination reports of other agencies and to conduct their own examination of institutions under their jurisdiction.

The criteria used by the Hunt Commission in developing its proposals were uniformity in the regulation of competing institutions; preservation of the dual system of chartering, examination, and supervision; efficiency; and regulatory specialization in conformity with the specialization of financial institutions.

The Financial Institutions Act of 1973

Many of the Hunt Commission recommendations were later embodied in S. 2591 and debated in extensive hearings before the Senate Committee on Banking, Housing and Urban Affairs in 1973 and 1974. The proposed bill did not contain the Hunt Commission recommendations on structural reform, however, including only those concerned with the activities of financial institutions and the chartering of federal mutual thrift institutions.

In one proposal before the committee, the supervisory authority of the Federal Reserve Board was to be transferred to the FDIC to allow the former to focus on monetary policy. The new authority of the FDIC was limited to managing its insurance risk. The proponents of this view noted that two arguments are most commonly put forth in defense of Federal Reserve Board-conducted examination: that it is necessary for monetary policy formulation and for the proper operation of the discount window. Neither argument was found compelling; under the new system, the Federal Reserve Board would use the reports of the FDIC and the states. Furthermore, because the reports were made at varying points during the year, it was argued that they could not be properly aggregated and used as a basis for policy formulation. Finally, it was noted that the Federal Reserve Board's authority then extended only to state member banks, which represented only 21 percent of total deposits of insured banks, and therefore the data base was insufficient.

The Federal Banking Commission (1973)

In the same year as the proposed Financial Institutions Act, the consolidation of the federal financial regulatory agencies was advocated again in a staff report of the House Committee on Banking and Currency (U.S. Congress 1973). The proposal would have established a single agency, to be known as the Federal Banking Commission, incorporating the FDIC and the regulatory and supervisory functions of the Comptroller and the Federal Reserve Board. The issue and redemption of currency would be administered by the Treasury, eliminating the Comptroller altogether, and the Federal Reserve Board's activities would be restricted to monetary policy. The plan was intended to eliminate regulatory waste and overlap, as well as leniency in control and supervision. It was also thought that the plan would ameliorate relations between federal and state regulatory authorities by combining the former into a single unified body.

Compendium of Major Issues in Bank Regulation (1975)

In 1975 the chairman of the Senate Banking Committee solicited a number of papers from nongovernmental experts on the question of structural reform, which resulted in a published volume containing several new proposals. One plan (Benston 1975) would have granted the FDIC sole authority to conduct examinations of banks, but did not accord "any authority over charter and branch applications and mergers, except where there is a clear danger of solvency of a bank." Power to conduct examinations would be vested in the FDIC because, of the three federal banking regulatory agencies, it was regarded as having the most interest in preventing bank failures. The other functions were removed from FDIC jurisdiction to balance the tendency toward conservatism in examination.

Another study argued that the FDIC should be accorded all regulatory authority over insured banks (Whittlesey 1975). That was because the largest number of banks fall under the FDIC's responsibilities, and because the FDIC suffers more consequences from bank failure. The potential for overly stringent regulation resulting from such an arrangement was viewed as less costly than the inefficiencies and inconsistencies of the current system of fragmented regulatory authority.

The same paper also presented several reasons for removing the examination and supervision functions from the Federal Reserve Board. These activities were viewed not only as a diversion of energies from the Federal Reserve Board's primary duty of conducting monetary policy, but also as a potential conflict of interest. A distinction was drawn between the objectives of liquidity and solvency, the point being that the Federal Reserve Board's role in assuring liquidity is commonly misconstrued as a responsibility for solvency. This assumption leads to a conclusion that the Federal Reserve Board must work toward minimizing bank failures, a function involving the conduct of periodic examinations and supervision. In fact, the Federal Reserve Board's mandate necessitates only access to examination reports, which could be prepared by other agencies. To resolve problems of interagency coordination, the study argued that communication between departments of one agency is not inherently more smooth and effective than between two separate organizations.

The proposal was again made for a Federal Banking Commission in charge of all regulatory and supervisory activities and organized with a separate division to carry out insurance procedures. Among the usual arguments of efficiency and consistency was a predominant concern over the tendency toward laxity in supervision resulting from the current arrangement. During the preceding year, two of the largest banks in the United States--Franklin National Bank and U.S. National Bank of San Diego--had failed, causing renewed concern over the adequacy of the existing system of bank overview. Among other points raised on the issue of regulatory reform were that regulatory and supervisory functions should not be carried out by the same organization that insures banks because what might appear to be "least cost" from the narrow point of view of that organization might not be "least cost" to the economy as a whole (Sheehan 1975).

FINE Study (1975)

The next major set of hearings on the question of structural reform of the regulatory apparatus occurred in 1975 before the House Committee on Banking, Currency and Housing. The hearings resulted in four volumes of reports and testimony, entitled Financial Institutions and the Nation's Economy (FINE) "Discussion Principles." The FINE study proposal was actually the first to recommend that all of the federal banking regulatory bodies be consolidated into a single new agency. This Federal Depository Institution Commission would assume all functions of the Comptroller, FDIC, FHLBB, and NCUA, and the regulatory and supervisory functions of the Federal Reserve Board. One witness before the committee remarked that consolidation of the federal financial regulatory agencies should depend on the extent to which the two industries became homogeneous in function. As long as savings and loan associations remained the primary source of funds for residential mortgages, there should be an agency such as the FHLBB with the specific responsibility for assuring the even and adequate flow of capital into that market (U.S. Congress 1976, 301-311).

Another witness supported the concept of a single federal regulatory agency, contending that supervisors were more likely to enforce regulations that came from their own organization than from one regarded as a competitor. The functions of examination and supervision should not be separated because this would result in "weak examination and uninformed supervision" (U.S. Congress 1976, 318-327).

A third witness advocated the functional realignment of the existing agencies in place of the FINE study consolidation proposal (U.S. Congress 1976, 489-493). The allocation of duties would be as follows: the Comptroller would be responsible for optimizing individual bank performance and would be granted the power to determine the activities that banks could conduct. The FDIC would be in charge of the safety and soundness of banks and would have the authority to conduct all bank examinations and to declare banks insolvent. The Federal Reserve System would be responsible for maintaining the competitive structure of the banking system and would be accorded jurisdiction over mergers. This system differed from the FINE proposal in that the various functions would remain under separate organizations rather than within distinct administrative units of a single agency. This alternative was intended to avoid the dangers inherent in the concentration of power and to assure that conflicts in goals between the different functions would be debated openly, with Congress as the final arbiter.

A consumer representative argued in favor of consolidation because restructuring the current tripartite scheme could remove resistance to reform in other areas of banking regulation. A single federal regulatory agency might be dominated by the commercial banks, however, so the creation of a Federal Banking Agency for Stock Institutions and a Federal Banking Agency for Mutual Institutions were proposed. The latter would supervise mutual savings and loans, mutual savings banks, credit unions, and newly created mutual commercial banks.

A contrary view was that the federal regulatory apparatus of S&Ls was already too centralized, resulting in repressive supervision. Furthermore, federal authority over the savings and loan industry should not be combined with its authority over the banking sector; that would result in second-class status for the S&Ls because of the larger total size of bank assets. Consolidation of the federal insurance functions would still be possible, but only if the new agency remained separate from the other federal agencies in charge of chartering, regulating, and examining banks and savings associations. This would avoid any bias toward federally chartered financial institutions by the insuring body (U.S. Congress 1976, 844-855, 1224-1265).

The case against a Federal Depository Institutions Commission was also made by the Comptroller of the Currency, who argued that the division of responsibilities among the three banking regulatory agencies was already efficient enough. He conceded that some research and training overlap existed among the Comptroller, the Federal Reserve Board, and the FDIC, but maintained that this could be eliminated if each agency curtailed its own expenditures in these areas. To improve regulatory consistency, he supported a proposal by the Federal Reserve Board to establish a Federal Bank Examination Council, which would develop uniform standards and procedures for bank surveillance, examination, follow-up, and review of problem cases. The three federal banking regulatory agencies, as well as the state regulatory authorities, would be represented on the council. As a second measure to facilitate interagency coordination, the Comptroller recommended that the Federal Reserve Board designate one governor to exercise exclusive authority over bank supervision who would sit as the third member on the FDIC board of trustees.

The Consolidated Banking Regulation Act of 1979

Introduced to Congress in February 1979 as S. 332, this proposal was less ambitious than the FINE recommendations. It would have consolidated banking examination, supervision, and regulation into a five-member Federal Bank Commission, but it did not propose changes in the regulation of thrifts or credit unions. The intention of the proposal was to ". . . better insure the safe and sound and competitive operation of the commercial banking system" (U.S. Congress 1979, sec. 1). The act recognized the need to strengthen the dual banking system and to allow the Federal Reserve to concentrate on its monetary policy responsibility.

Opposition to the proposed bill by the Federal Reserve, the Conference of State Bank Supervisors, and the American Bankers Association was based on concern over excessive concentration of regulatory authority and the resulting decrease in innovation. Furthermore, the successful performance of the banking industry was regarded as an indication of the adequacy of the current regulatory system. Opposition to S. 332 was also based on the fact that in the previous year, a council had been established under title X of the Financial Institutions Regulatory and Interest Rate Control Act to develop a method of coordination among the agencies. The council, composed of the heads of all regulatory agencies of financial institutions, had no substantive authority but was designed as an interim step toward consolidation. Those speaking against S. 332 argued that the passage of a reform proposal would obviate the council, which they considered an important forum for the exploration of reform alternatives.

Garn-St Germain Depository Institutions Act of 1982

The Garn-St Germain Act did not change the financial regulatory structure, but it did contain provisions facilitating an eventual consolidation of the insurance agencies. The substantial new asset and liability powers will reduce some of the historical distinctions between banks and thrift institutions. The authority of the FDIC was liberalized to permit provision of ongoing assistance to weak banks under the same circumstances that apply to the FSLIC. Savings banks can convert to federal charters under the FHLBB and retain their FDIC insurance. In addition, the chartering of federal associations was liberalized to reduce the distinctions and barriers between industries.

Current Reform Proposals

In late 1981, the chairman of the Securities and Exchange Commission (SEC) called for an overall examination of the financial regulatory structure with a view to eliminating existing anomalies and overlaps. The need for regulatory reform was reiterated in testimony before the Senate Subcommittee on Securities in early 1982. The chairman recommended (U.S. Congress 1982, 29) the establishment of a nonpartisan task force consisting of "experienced executives and recognized authorities" with a one-year mandate to "develop a framework for legislation to update, simplify and rationalize the system." The approach of the task force would be to convert to a system of regulation by function rather than structure. A major result would be to make consistent the regulations that apply to commercial banks, S&Ls, and credit unions, all of which receive customer deposits, provide checking services, and make loans. In an SEC conference in October 1982, other areas of regulatory discrepancy resulting from the structural approach were noted: money market funds versus bank deposits, brokerage services offered by banks versus those offered by securities firms, and registration of corporate securities offerings by depository institutions versus their holding companies even when the S&Ls or bank may be the holding company's only major asset.

The notion of regulation by function was embodied in a House bill (H.R. 7014) to establish a commission on capital markets to study the securities activities of commercial banks and to make long-term recommendations. The broader issue of regulatory reorganization has now been taken up by an executive branch task force led by Vice President George Bush and consisting of the heads of six federal financial regulatory agencies--the Federal Reserve, FHLBB, FDIC, Comptroller, NCUA, and Commodity Futures Trading Commission--in addition to the U.S. Attorney General, the assistant to the President for policy development, and the chairman of the Council of Economic Advisors.

SUMMARY

The current complex structure of the federal financial regulatory and deposit insurance system developed piece by piece over the past 70 years, as each new financial institution--banks, S&Ls, credit unions--was created. With regard to the powers of the federal deposit insurance agencies, the FDIC holds authority to regulate, examine, and supervise banks that it insures, although it does not necessarily implement each power. The FSLIC and the NCUSIF have less authority, acting as the insurance arms of their respective parent agencies--the FHLBB and the NCUA. However, all three insurance agencies provide the same amount of deposit coverage--up to the first $100,000, with immediate and complete repayment--and levy the same gross premium--1/12 of 1 percent of total deposit liabilities.

As a result of the piecemeal evolution of these overlapping, parallel, and specialized agencies, several issues are engendered in any consolidation proposal. With regard to legal status, new legislation would be required to combine agencies mandated at different times by separate acts. The power of a consolidated agency is another major issue: should merger involve the management of only the insurance funds; the creation of a new superagency with all chartering, insurance, supervisory, and liquidity powers; or some compromise position between these two extremes?

Other consolidation issues that are important include the problem of regulatory capture, where the regulator favors the regulated industry over the public interest; the gaps and overlaps of regulatory power among the federal financial agencies; the coordination of assistance operations for troubled financial institutions; competing objectives of specialized insurance agencies; the cost savings that might be realized through consolidation of the administration and reserves of the insurance agencies; the problem of cross-industry transactions, currently impaired by conflicting regulations; the difference in risk inherent in the separate financial industries; and various transition problems concerning fears of bias by the surviving agency, differing approaches to assisting failing institutions, and the comparative weaknesses and strengths of each financial industry.

Such issues have been studied and debated throughout the history of the federal deposit insurance agencies. Numerous proposals to reform the emerging complex of financial regulatory and insurance agencies have been forwarded to Congress. These include the work of commissions (both Presidential and Congressional), Senate and House investigations and studies of the financial industry, and several proposed (but not enacted) reform bills.

The debates on reform of the financial regulatory structure are striking in two respects. One is the sheer number of studies, panels, commissions, and recommendations that have been forthcoming in a nearly continuous flow since the early years of regulation in this century. The other remarkable feature has been the repetitiveness of the arguments on all sides of the issue. One must therefore conclude that the time for study has passed. A decision on whether and how to reorganize the system must now be made on the basis of available information.

The weight of evidence indicates that the current patchwork arrangement has been adequate for an era of strict industry regulation. Although no one would design such a system if starting anew, its shortcomings have been offset by some modest advantages of diversity. The financial industry now faces a future that will be different and unpredictable. Existing weaknesses in the current regulatory scheme--such as the coordination problem in interindustry matters--will come under increasing pressure while the system's strength--its openness to diversity--will fade in importance as the unregulated market provides the spark of innovation. The emerging economic environment demands corresponding changes in the regulatory structure, and those needed reforms go beyond the three deposit insurance agencies.

In particular, consolidation of the insurance should not be initiated without first rationalizing the functions of the financial regulators. Any reorganization, moreover, need not be radical or immediate. Transition issues loom large. The process of structural change must proceed in concert with implementation of other reforms in deposit insurance. Correctly designed, a system of risk-sensitive insurance premiums and capital adequacy standards could substitute market-like incentives for much existing command-and-control regulation.

APPENDIXES

APPENDIX A

INDEXES OF RISK

(603)

A simple linear combination of separate indexes of risk might be used as an overall index that can be used to determine risk-sensitive premium rates for deposit insurance. The first part of this appendix presents a conceptual framework that suggests how the separate indexes might be combined. The second part of this appendix presents a discussion of an interest rate risk measure, along with an illustration of how it can be computed on a practical basis.

COMBINING SEPARATE RISK INDEXES

The type of overall index suggested here is a simple linear combination of separate risk indexes. For illustration purposes, suppose it includes just two risk indexes, one reflecting interest rate risk (call it IRR_i, for the interest rate risk measure for the *i*th savings and loan association (S&L) and the other reflecting credit risk (CR_i). The overall index for the *i*th S&L (or savings bank) then can be written as

$$I_i = a_1 \; IRR_i + a_2 \; CR_i. \qquad (1)$$

The coefficients a_1 and a_2 are determined by, according to the analysis here, two factors. The first is the relative relationship between the selected risk indexes IRR_i and CR_i, on the one hand, and on the other, the projected market net worth of the association under adverse conditions when interest rate risk exposure and credit risk exposure, respectively, would be severe. This relationship is based on how well the separate risk indexes represent the risks, and thus depends on which measures of these risks are used.

The second factor that determines the relative weights a_1 and a_2 is the relative degree of belief held by the Federal Savings and Loan Insurance Corporation (FSLIC) that economic circumstances would lead to interest rate risk problems and credit risk problems, respectively, along with an assessment of the types of circumstances the FSLIC would like to protect itself against. The choice of values for a_1 and a_2 is necessarily at least partially subjective, because it is based on the FSLIC's perceptions about the future economic environment.

An Expected Value Approach

Conceptually, a risk-sensitive premium system can be structured to assess a larger premium on S&Ls that pose a greater risk to the FSLIC. The FSLIC's risk can be defined in terms of payouts: the larger the payout, the greater the risk of fund depletion. Further, because of the use of competitive bids for takeover partners, payouts are approximately equal to the (negative) market value of net worth at the time of disposal of the firm.

For a given S&L, the FSLIC can, conceptually at least, calculate the expected value of a payout. Understanding the steps taken in making this computation is important because they serve as a basis for constructing an index on which to base a simple, applied risk-sensitive premium system. Also, once the method of computation is understood, inferences can be drawn concerning two fundamental issues in risk-sensitive premium structures: the integration of various kinds of risk indexes into a premium formula, and the role of net worth in the premium calculation.

There are four basic steps to computing an expected payout for a given S&L. A fifth step computes the relative expected payout for all insured S&Ls, and this serves as a single, overall index of risk. Conceptually, this index can be used in a risk-sensitive premium formula. The five steps are: (1) specify possible future events; (2) assign probabilities to those events; (3) compute the market value of net worth for each S&L for each event; (4) compute the expected payout; and (5) compute a risk-sensitive premium index.

Step 1: Specify possible future events. Conceptually, premiums should be made on a prospective basis; that is, they should be based on possible future events. One S&L would then pay a higher premium if, in the future, it is likely to be more risky to the FSLIC than another. Consequently, the first step is to specify alternative possible events for a specified period of time in the future. These events may also be denoted as "outcomes," "economic scenarios," or "states of the world." Outcome 1, for example, could be a scenario in which interest rates rise to their previous peak levels; outcome 2 could be a deep recession; outcome 3, a continuation of current market conditions; and so on.

Step 2: Assign probabilities to outcomes. The second step is to assign a probability to each of these outcomes. These probabilities are necessarily subjective. They are not like the probabilities used in most insurance schemes, in which the relative frequencies of past occurrences are used as approximations. In Step 1, conceptually at least, all the major distinct outcomes that have a non-zero chance of occurring should be specified. For practical applications, relatively few outcomes need be specified.

The insurance agency must assign the probabilities. The assignment of probabilities does not have to be governed strictly by the FSLIC's evaluation of the likelihood of events. From a more general point of view, the FSLIC may want to protect its fund more from the risk of rising interest rates than from the risk of recession. Thus, the probability or, more generally, the weight assigned to the first outcome may be increased, and the weight assigned to the second decreased, from what would otherwise be straightforward (yet subjective) probabilities of occurrence. In other words, the weights can be thought of as a method for the FSLIC to impose its preferences about the kinds of risk it wants to avoid, as well as including an element of forecasting. (In a more formal presentation of the underlying theory, the considerations here would be introduced as part of the FSLIC's loss function.) As is shown below, these weights should be reflected in practical applications of any risk-sensitive premium formula that involves more than one measure of risk (such as separate measures of interest rate and credit risk).

Step 3: Compute the market value of net worth. Given each specification of possible outcomes in Step 1 and given the S&L's current financial condition and operating environment, the FSLIC then projects the market value of the S&L's net worth (NW). This is ordinarily done in financial planning. The estimation errors known to be inherent to any such projection will be ignored for purposes of this discussion, because this procedure is likely to be used in practical risk-sensitive premium formulas only in a general, conceptual way.

Net worth projections are made for each of the specified outcomes, for each of the insured S&Ls, for a specified period of time. (It is not important here what that time period is specified to be.)

Step 4: Compute expected payout. The expected value of the FSLIC's payout for each S&L is a weighted average of net worth over all those outcomes for which net worth is negative (i.e., for which there is, given the specified outcome, an FSLIC payout). The weights are the probabilities of those events occurring, modified to accommodate FSLIC's risk aversions. Notationally, for the $\underline{i}$th S&L:

$$EP_i = \sum_{j=1}^{J} (-NW_{ij})p_j \quad \text{for outcomes } j \text{ with } NW_{ij} < 0 \qquad (2)$$

where

EP_i = expected value of FSLIC's payout for the ith S&L;

NW_{ij} = market value of the ith S&L's net worth under outcome j;

p_j = probability assigned (by FSLIC) to the jth outcome; and

J = total number of outcomes specified.

This expected payout computation represents a measure of the risk that the S&L poses to the FSLIC. If this number is large so that the risk is great, and the FSLIC can do something about it, then the outcomes projected in Step 3 should be modified. Conceptually at least, projections of net worth should be based on the events that are expected, including the reactions of the S&L either to a given financial environment or to the direction given by the FSLIC. Such refinements are assumed to be made in the projections. This general approach to measuring risk is more conceptual than practical, so such an assumption is not critical.

Another approach could be applied here, although the subsequent analysis would not change to any significant degree. This alternative approach assumes that the FSLIC has a target cutoff point for taking over failed institutions. The target could be any number of alternative specifications, such as zero net worth at book value, zero net worth at market value, or a negative 1 percent market-net-worth-to-assets ratio. If a target is met, FSLIC payouts may be bounded. They are not likely to be bounded in any substantial way if the target is measured in book value terms, so the formulation of the expected payouts presented above would generally apply. But if the targets are in market value terms, then payouts may be bounded, within some tolerance level.

However, measurement error and other problems of detection and enforcement imply that targets, if they exist, are likely to be missed. This type of operating environment can be modeled by assuming that FSLIC payouts, although random in nature about the target level, are nevertheless a function of the rate of change in net worth. As projections are being made for each economic scenario, then, the change in market net worth from the current time to the projected time can serve as a measure of the FSLIC's payout risk. This change can be denoted as NW. For all those outcomes j for which net worth is at or below the target, simply substitute $-\Delta NW_{ij}$ for $-NW_{ij}$ in the above expected value formula. Then the expected payout measure EP_i is no longer a measure of payouts; it becomes a measure of the relative risk of various payouts among S&Ls. Because that is the purpose of the EP measure, such a change in the computations does not detract from the analysis. Below, simply substitute ΔNW_{ij} for NW_{ij} to accommodate this analysis; only at one point will the analysis change. That point is the relationship between selected risk indexes and market net worth under adverse circumstances. Using the NW_{ij} measure, these indexes are to represent the market net worth under the respective adverse circumstances; using the ΔNW_{ij} measure, these indexes are to represent the rate of change in market net worth under the respective adverse circumstances.

Step 5: Compute a risk-sensitive premium. A risk-sensitive premium index can then be computed for each S&L, based on its relative expected FSLIC payout. Table A-1 summarizes the calculations discussed in the previous steps, and shows that the total expected payout (TEP) for the FSLIC is just the expected payouts of each S&L summed over all S&Ls. An index (call it R_i) that shows the relative contribution of the ith S&L to the total expected payout is thus

$$R_i = \frac{EP_i}{TEP} . \qquad (3)$$

For two S&Ls, the one with a higher R_i index should pay a higher insurance premium, because the risk it presents to the FSLIC is relatively greater.

Assume that there are only two specified outcomes; call the first one a return to very high interest rates and the second one a deep recession. Assume further that the first outcome represents only interest rate risk, while the latter represents credit risk. Also assume that the probabilities the FSLIC assigns to the two outcomes are p_1 and p_2, respectively, and that the market value of net worth of an arbitrarily selected S&L (the ith S&L) is estimated at NW_{i1} and NW_{i2} for the two outcomes and that both of

Table A-1. Schematic Illustration of an Expected FSLIC Payout Computation

	Outcome:	1	2	3	...	J	
S&L	Probability:	p_1	p_2	p_3	...	p_J	Expected Payout
1		NW_{11}	NW_{12}	NW_{13}	...	NW_{1J}	$EP_1 = \sum_{j=1}^{J} (-NW_{1j})p_j$ for $NW_{1j} < 0$
2		NW_{21}	NW_{22}	NW_{23}	...	NW_{2J}	$EP_2 = \sum_{j=1}^{J} (-NW_{2j})p_j$ for $NW_{2j} < 0$
.		.	.	.		.	.
.		.	.	.		.	.
.		.	.	.		.	.
N		NW_{N1}	NW_{N2}	NW_{N3}	...	NW_{NJ}	$EP_N = \sum_{j=1}^{J} (-NW_{Nj})p_j$ for $NW_{Nj} < 0$
							$TEP = \sum_{n=1}^{N} EP_n$

Notation: NW_{ij} = Market value of net worth of S&L i under outcome j
EP_i = Expected value of the FSLIC's payout for the ith S&L
p_j = Probability assigned (by the FSLIC) to the jth outcome
J = Total number of outcomes specified
N = Total number of insured thrift institutions
TEP = Total expected value of FSLIC's payouts (summed over all the S&Ls)

these are negative (or zero). Then the expected FSLIC payout for this *i*th S&L is computed as

$$EP_i = (-NW_{i1})p_1 + (-NW_{i2})p_2 \ . \tag{4}$$

Dividing both sides of this equation by FSLIC's total expected payout (TEP) and using (3) yields the equation for the overall risk measure based on the expected value of payouts approach:

$$R_i = \frac{EP_i}{TEP} = \frac{-NW_{i1}}{TEP} p_1 + \frac{-NW_{i2}}{TEP} p_2 \ . \tag{5}$$

The indexes for interest rate risk and credit risk, if they are to be useful, are assumed to stand for the relative net worths at market value under the respective adverse sets of circumstances. Considering the FSLIC's total expected payout, TEP, as a constant scale factor, the implicit assumption about the usefulness of the separate risk indicators is now made explicit. It is assumed that the interest rate risk index IRR_i is proportional to the market value of net worth under the adverse interest rate scenario:

$$IRR_i = k_1 \ \frac{-NW_{i1}}{TEP} \ . \tag{6}$$

Similarly, it is assumed that the credit risk index CR_i is proportional to the market value of net worth under the deep recession scenario:

$$CR_i = k_2 \ \frac{-NW_{i2}}{TEP} \tag{7}$$

where k_1 and k_2 are constants. (If the "target" net worth approach is used, as discussed above, the risk measures would have to stand for the rate of change in market net worth instead of the level of market net worth.) These equations can be rewritten as:

$$\frac{IRR_1}{k_1} = \frac{-NW_{11}}{TEP} \quad \text{and} \quad \frac{CR_1}{k_2} = \frac{-NW_{12}}{TEP} . \tag{8}$$

Substituting these expressions in the overall interest rate risk measure R_1 gives

$$R_1 = \frac{P1}{k_1} IRR_1 + \frac{P2}{k_2} CR_1 . \tag{9}$$

For contrast, restate the "applied" overall risk index I_1:

$$I_1 = a_1 \ IRR_1 + a_2 \ CR_1 . \tag{1}$$

In order for the intuitive index I_1 to equal the index based on the expectational approach (R_1), a_1 and a_2 must be

$$a_1 = \frac{P1}{k_1} \tag{10}$$

and

$$a_2 = \frac{P2}{k_2} . \tag{11}$$

Thus, the relationship between a_1 and a_2 can be expressed as

$$\frac{a_1}{a_2} = \frac{k_2}{k_1} \frac{P1}{P2} . \tag{12}$$

Implications of Combining Separate Indexes

What has been demonstrated in this simple case is that the relative magnitudes of the weighting coefficients a_1 and a_2 depend on two factors. The first is the ratio of the constants of proportionality k_2 and k_1 that relates the risk measures to measures of the market value of net worth (or, under the alternative "target" formulation, to the rate of change in market net worth). What is important is the relative magnitudes of k_1 and k_2, and this depends on the degree to which the IRR_i measure changes in response to a unit change in NW_{i1} relative to how the CR_i measure changes in response to a unit change in NW_{i2}. For discussion purposes, consider a duration gap index as a measure of interest rate risk, and a bad debt index (such as "real estate owned and scheduled items") as a measure of credit risk. It is likely that the former would have a close relationship to market net worth projections under an adverse interest rate scenario, while the relationship between changes in bad debts and changes in projected net worth under a deep recession scenario would be fairly weak. The ratio of k_2 to k_1, then, may be about 0.6, to select an arbitrary figure.

The second factor that determines the relative weights a_1 and a_2 in the applied index formula I_i are the subjective probabilities of the outcomes for which the IRR_i and CR_i indexes stand. That is to say, if adverse interest rate movements are thought to be more likely than a deep recession, or if the FSLIC wants to protect itself more from that outcome, then p_1 should be greater than p_2. If the ratio of p_1 to p_2 is 5 to 1, while the ratio of k_2 to k_1 is 0.6, then the ratio of a_1 to a_2 is $5(0.6) = 3$. Letting a_1 and a_2 sum to unity, a formula weighing the two kinds of risk could be

$$I_1 = .75\ IRR_1 + .25\ CR_1\ . \qquad (13)$$

That is, the interest rate risk index receives 75 percent of the weight, while the credit risk index receives 25 percent of the risk.

In Table A-1, it is assumed that all (major) possible outcomes are specified, and that the probabilities assigned to each outcome are forward-looking. If some outcome arises in the future that cannot be perceived at this time, or whose likelihood of occurrence is now assumed to be low, then a risk-sensitive premium formula designed today will not be able to include it or will give it a low weighting factor. But that is the nature of the problem. There are not enough date on relative frequencies of events to assign probabilities accurately to them. The risk-sensitive premium formula, in other words, is necessarily based on subjective evaluations (the weights) as well as on objective ones (the measures of risk).

Adjustments for Net Worth

Another refinement is important if the indexes themselves do not account for the initial net worth of the S&L. In the example used, if the interest rate risk measure IRR_i and the credit risk measure CR_i are independent of the S&L's initial market net worth, then a separate adjustment to the premium rate is necessary. The proper kind of adjustment can be inferred by returning to the original conceptual framework and restricting it to just two outcomes, high interest rates and deep recession.

Assume that there are two S&Ls that have the same asset and liability composition, and thus they receive the same scores for the interest rate risk and credit risk indexes. However, assume that the first S&L has a 10 percent net-worth-to-assets ratio while the second one has only a 2 percent net-worth-to-assets ratio. Table A-2 illustrates the computation of the expected FSLIC payouts for these two S&Ls. The one with the higher initial net worth, S&L No. 1, has an expected payout of zero compared with an $11.0 expected payout for S&L No. 2. Consequently, according to the risk they pose to the FSLIC, the second one should have to pay a higher premium. (The first S&L should probably have to pay just a minimum premium.)

Unfortunately, the conceptual framework cannot indicate a unique way in which such an adjustment for net worth is to be carried out, because net worth projections are usually complex functions of the projected environment and institution-specific factors. But several inferences can be drawn and some suggestions made. First, the present market value of net worth is conceptually a more important determinant of projected market values than the

Table A-2. Illustration of Expected Value of the FSLIC Payout[a]

	Outcome:	High Interest Rates	Depression	
	Probability:	75%	25%	Expected Payout
S&L No. 1 (with 10% net worth)		1	2	0.75(0) + 0.25(0) = 0 (Net worth is positive)
S&L No. 2 (with 2% net worth)		-13	-5	0.75(13) + 0.25(5) = 11.0

[a] Numbers given in the table are projections of the market value of net worth.

present book value of net worth. A cursory examination of the relationship between book value and market value demonstrates that book net worth is not a good equivalent for market value. For June 30, 1982, the squared correlation coefficient between the two measures (for all reporting S&Ls) was -0.70. That is, the correlation was negative; higher book values were associated with lower market values. (This result was derived from data developed by the Expanded Task Force on Current Value Accounting (Federal Home Loan Bank Board, in press). The major factor used to determine market net worth was the discount on the mortgage portfolio. Factors that would be included in a true market net worth calculation, such as the value of fixed assets and goodwill, were not included in these estimates.)

Second, whatever adjustments are made to the premium should allow an S&L with a high level of market net worth to pay only the minimum premium rate. Regardless of the riskiness of the S&L's assets, the FSLIC is protected as long as the S&L has sufficient net worth at market value. Asset losses then can come out of net worth under a wide range of possible future economic conditions.

Third, in terms of an applied formula such as $I_i = a_1 \, IRR_i + a_2 \, CR_i$, adjustments for net worth can be made for each separate risk index, IRR_i and CR_i. This may make some sense because of the different relationships between the indexes and net worth that are difficult to capture in the coefficients a_1 and a_2.

However, different adjustments for net worth add a layer of complexities. If the adjustment is the same for both indexes, it does not matter whether the adjustment is made on both indexes separately or on the overall index I_1. It also does not matter whether the adjustment is made to the premium rate RSP_1 or to the overall index I_1.

INTEREST RATE RISK EXPOSURE

A financial intermediary is exposed to interest rate risk when interest rate changes affect the market value of its cash assets and liabilities by different amounts. For example, if a general increase in interest rates results in a decrease in the market value of assets by $10 million but decreases the value of its liabilities by $5 million, the net worth of the intermediary in market value terms decreases by $5 million. A continuous deterioration of the intermediary's financial position can make it unable to discharge its liability commitments and can result in insolvency and bankruptcy. Interest rate risk depends, therefore, on the relative impact of interest rate changes on the intermediary's assets and liabilities.

The impact of interest rate changes on the cash (spot) assets and liabilities of an institution may be measured by their respective durations. The duration of a set of securities is the weighted average life of the securities, measured as an average of the length of time to the dates on which payments are received, weighted by the present values of the respective payments. Mathematically, duration is defined most simply as

$$D = \frac{\sum_{t=1}^{N} \frac{tF_t}{(1 + i)^t}}{\sum_{t=1}^{N} \frac{F_t}{(1 + i)^t}} \tag{14}$$

where F_t is the cash flow occurring at time t in the future, i is the rate of interest (yield to maturity), and N is the date of the last flow (Macaulay 1938).

Redington (1952) showed that, when the initial present values of a financial intermediary's assets and liabilities are equal, the impact of subsequent interest rate changes on its net worth is determined by the difference between the durations of the institution's assets and liabilities (including net worth). The current (market) value of the institution's assets (A) is the discounted value of its expected future income flows from the present to the last period N, or

$$A = \sum_{t=1}^{N} \frac{F_t^A}{(1 + i)^t} . \tag{15}$$

Likewise, for its liabilities (L)

$$L = \sum_{t=1}^{N} \frac{F_t^L}{(1+i)^t} . \tag{16}$$

The impact of a change in interest rates on net worth may be written as

$$\frac{\Delta(A-L)}{\Delta i} .$$

Equating with the flow equivalents from equations (15) and (16) and using calculus yields, at first approximation,

$$\frac{\Delta(A-L)}{\Delta i} = -\frac{\sum_{t=1}^{N} \frac{tF_t^A}{(1+i)^t}}{(1+i)} + \frac{\sum_{t=1}^{N} \frac{tF_t^L}{(1+i)^t}}{(1+i)} . \tag{17}$$

Equation (14) may be rewritten for assets as

$$\sum_{t=1}^{N} \frac{tF_t^A}{(1+i)^t} = D_A \sum_{t=1}^{N} \frac{F_t^A}{(1+i)^t}$$

and substituting from Equation (15)

$$\sum_{t=1}^{N} \frac{tF_t^A}{(1+i)^t} = D_A A .$$

The same holds for liabilities; thus, equation (17) may be rewritten

$$\frac{\Delta(A - L)}{\Delta i} = - \frac{D_A A}{(1 + i)} + \frac{D_L L}{(1 + i)} .$$

Remembering that A = L and collecting terms

$$\frac{\Delta(A - L)}{\Delta i} = - \frac{(D_A - D_L)A}{(1 + i)}$$

or

$$\Delta(A - L) = - (D_A - D_L)A \frac{\Delta i}{(1 + i)} = \Delta NW . \qquad (18)$$

The difference between the durations of the assets and liabilities in equation (18) is the duration "gap," which can be written as

$$Gap = D_A - D_L . \qquad (19)$$

The gap may be scaled in years.

If the asset and liability durations are equal and the assets and liabilities are both marked to market values, the gap is zero and the intermediary is exposed to no interest rate risk. In effect, the intermediary is a conduit; any change in interest rates is passed through from one side of the balance sheet to the other on a one-to-one basis. A special and restrictive case of this is when cash outflows and inflows are perfectly matched. If the duration of the assets exceeds that of the liabilities, the duration gap is positive and any increase (decrease) in interest rates reduces (increases) the value of the assets more than the value of the liabilities and, hence, decreases (increases) net worth. The duration gap can serve as an index of interest rate risk because it measures the relative impact of interest rate changes on the market values of the assets and liabilities. The larger the gap, the larger is the value of the risk index, and the larger is the change in net worth for any given change in interest rates.

The calculation of duration is difficult and complex; however, it is possible to avoid the calculation. As is shown below, the duration gap can be approximated from relative changes in the market value of the assets and liabilities. It can be shown that, at first approximation,

$$\frac{\Delta A}{A} = -D\left(\frac{\Delta i}{1 + i}\right) \qquad (20)$$

(Hopewell and Kaufman 1973). Thus, the relative change in the price of a security can be calculated for any change in the yield to maturity if the duration is known. By rearranging terms in 20, it follows that

$$D = -\frac{\Delta A}{A} \cdot \frac{(1 + i)}{\Delta i} \cdot \qquad (21)$$

Thus, the durations can be approximated by the proportional change in market price multiplied by an interest rate factor. By rearranging terms in equation (18), the duration gap can be approximated as

$$\text{Gap} = D_A - D_L = \frac{\Delta L - \Delta A}{A} \cdot \frac{(1 + i)}{\Delta i} \cdot \qquad (22)$$

Although durations are difficult to compute, the gap can be approximated by computing the market values on the right side of equation (22). This may be done in several steps.

Step 1. Assume that the interest rates used to calculate the market value of assets and liabilities increase by a given amount. The corresponding difference in the changes of the market values of the liabilities and assets can be denoted as

(change in liabilities - change in assets).

Step 2. Divide the difference in step 1 by the market value of assets to form the ratio:

$$\frac{\text{(change in liabilities - change in assets)}}{\text{assets}} \, .$$

In this way different intermediaries with different levels of assets can be compared. An institution that is twice as large as another may have this same ratio so that both would have the same degree of interest rate risk.

Step 3. The given change in interest rates used in step 1 was arbitrary. In order to have an index of interest rate risk that tends to be insensitive to this arbitrary change, multiply the ratio in step 2 by the ratio:

$$\frac{\text{1 plus the level of interest rates}}{\text{given change in rates}}.$$

The resulting index can be written as

$$\frac{\text{change in liabilities} - \text{change in assets}}{\text{assets}} \times \frac{\text{1 plus the level of interest rates}}{\text{change in rates}}.$$

This renders an index that is insensitive to the size of the change in interest rates; the larger the change in rates in the denominator of the latter ratio, the larger the numerator in the former ratio. These increments to the changes cancel out. For example, if the "change in rates" is multiplied by 10, the "change in liabilities - change in assets" is approximately multiplied by 10. The 10s cancel. The level of rates included in the formula indicates that the degree of interest rate risk generally changes with the level of rates. It is positive when the duration of assets is longer than that of the liabilities, and is negative when the duration of the assets is shorter than that of the liabilities.

To reduce its exposure to interest rate risk from increases in market rates, an institution can sell commercial paper, U.S. Treasury bonds, Treasury bills, Government National Mortgage Association certificates, or certificates of deposit in the futures market. It hedges its long cash position with a short futures position. In a short hedge position, the institution sells one of these instruments at a given price for delivery on a specific future date. As most futures markets require immediate settlement of daily gains and losses in prices, changes in interest rates that affect the price of open contracts produce immediate cash gains or losses. If interest rates increase, the value of the instrument to be delivered in the future will decrease so that the institution can buy the instrument on the delivery date at a lower price than it has contracted forward to sell it. These future gains are posted immediately to the institution. For example, suppose that an institution sells a $100,000 Treasury bond contract in the futures market for delivery in 90 days. The standardized U.S. Treasury bond sold at the exchange operated by the Chicago Board of Trade is an 8 percent, 20-year bond. If the market yield on this contract is 10 percent, the price is $82,844. If interest rates increase the next day to 10.102 percent, the futures price falls to $82,094, and the value of the open contract increases by $750. This amount is credited to the institution.

The profits in the futures market offset some or all of the decrease in the value of the institution's cash assets resulting from the increase in interest rates, and the institution has reduced its exposure to interest rate risk. If interest rates decrease, the implications are reversed. The institution will suffer losses on sales of futures contracts, but the value of its assets will increase. It should be noted that the institutions must be prepared to meet possible cash losses if they utilize the futures market to reduce their interest rate risk. These possible losses can be met from cash reserves and/or from the sale of assets whose values have increased. The risk of an open futures position may also be measured by the change in market value for a given change in interest rates.

Steps to the Interest Rate Risk Index

The calculation of the proposed index of interest rate risk involves three steps: the conversion of all cash and futures assets and liabilities on the balance sheet from book to market values; the calculation of changes in these values for a standardized change in the applicable market interest rates; the calculation of the index of interest rate risk, using the formula developed in this appendix. This index is then multiplied by the ratio of assets to net worth to determine the effective interest rate sensitivity gap.

The conversion of cash assets and liabilities from book to market value is accomplished in two steps. First, all of the assets, liabilities, and futures contracts are grouped into categories. Second, the market valuation of the assets, liabilities, and futures contracts within these groups is computed for market rates of interest which are provided by the insuring agency.

Next, the changes in the value of the assets, liabilities, and futures contracts are evaluated for a given equal change in market rates of interest for each group, say, of 100 basis points. The changes are summed and divided by the market value of total assets as follows:

$$\frac{\text{changes in liabilities} - \left(\text{changes in assets} + \text{changes in futures contract}\right)}{\text{market value of total assets}} .$$

This sum is multiplied by

$$\frac{\text{1 plus the level of interest rates}}{\text{change in interest rates}} .$$

The interest rate level in the formula is assumed to be an average rate, say, the 10-year Treasury rate. Last, the resulting index is multiplied by the initial market values of assets divided by net worth.

An Illustration of the Interest Rate Index

The four steps in the calculation of the interest rate index are illustrated here for a hypothetical savings and loan association. A very simplified balance sheet at book values for this savings and loan is illustrated in Table A-3. The market rates at which the assets, liabilities, and futures contracts are valued are shown in Table A-4. These rates are provided to the institution by the FSLIC. Table A-5 shows the computed market value of the assets, liabilities, and futures contracts. Note that net worth is lower

Table A-3. Balance Sheet at Book Value for a Hypothetical Savings and Loan Association
(Dollar Amounts in Millions)

Assets	
Cash, Demand Deposits	$ 5.0
Treasury Securities, maturity 2 years at 11% coupon	5.0
Residential Mortgages:	
5-year maturity at 14%	10.0
25-year maturity at 14%[a]	27.0
25-year maturity at 10%[a]	40.0
Other Loans, 2-year maturity at 15%	13.0
	$100.0
Liabilities	
Deposits and Savings Accounts:	
Passbook Accounts (assumed 1 year maturity), at 5.5%	$ 13.0
NOW Accounts (assumed 3 months), at 5.25%	8.5
Super NOW Accounts (assumed 3 months), at 11%	8.5
CDs, 1-year maturity, at 6.5%	4.0
CDs, 2.5-year maturity, at 6.75%	4.0
MMCs, 6-month maturity, at 13%	13.0
MMCs, 6-month maturity, at 12%	5.0
SSCs, 1.5-year maturity, at 12%	8.5
Jumbo CDs, 6-month maturity, at 13.5%	7.0
FHLB Advances, 1.5-year maturity, at 13%	10.4
	81.9
Net Worth	19.1
	$100.0
Open Futures Contracts	
Sell for 3-month delivery	
Treasury security, 20-year, 8%	5.0
GNMA security, 8%	5.0
	$ 10.0

---

[a] Assumed to be prepaid at end of the 12th year.

Table A-4. Hypothetical Prevailing Market Rates of Interest[a]

	Percent
Mortgage Loans	
5-year maturities	15
25-year maturities	16
Other Loans	15
Passbook Savings	8
CDs, 1-year maturity	12
CDs, 2.5-year maturity	13
NOW Accounts	12
MMCs	13
Jumbo CDs	14
SSCs	12
FHLB Advances	13
2-year Treasury rate	10
10-year Treasury rate	10
3-month GNMA futures rate	15
3-month Treasury futures rate	10

[a] These rates are provided by the FSLIC.

Table A-5. Balance Sheet at Market Value for a Hypothetical Savings and Loan Association
(Dollar Amounts in Millions)

Assets	
Cash, Demand Deposits	$ 5.00
Treasury Securities	5.09
Residential Mortgages:	
5-year maturity	9.78
12-year maturity at 14%	24.22
12-year maturity at 10%	27.91
Other Loans	13.00
	$85.00
Liabilities	
Deposits and Savings Accounts:	
Passbook Accounts, 5.5%	$12.82
NOW Accounts, 5.25%	8.36
Super NOW Accounts, 11%	8.48
CDs, 1-year maturity, 6.5%	3.80
CDs, 2.5-year maturity, 6.75%	3.45
MMCs, 6-month maturity, 13%	13.00
MMCs, 6-month maturity, 12%	4.98
SSCs, 1.5-year maturity, 12%	8.50
Jumbo CDs, 13.5%	6.98
FHLB Advances, 13%	10.40
	80.77
Net Worth	4.23
	$85.00
Open Futures Contracts	
Treasury Bond	4.14
GNMA Security	3.13
	$ 7.27

than its book value. This decrease results primarily from the large decreases in value of long-term low contract rate mortgages. Table A-6 shows the balance sheet of the hypothetical savings and loan after an increase in market rates of 100 basis points. Its net worth declines. Table A-7 computes the index of interest rate risk. For this hypothetical institution, the measure of interest rate risk is +1.86 years. This implies that the interest rate gap is positive so that the value of the assets changes more as a consequence of a change in interest rates than does the value of the liabilities. This is consistent with the decline in net worth. Lastly, this gap is multiplied by the ratio of assets to net worth (85.00/4.23 = 20.09). The resulting effective net interest rate sensitivity index is 37.4.

This institution is exposed to greater interest rate risk than an institution having a smaller index, say, 30, and to lesser risk than an institution having a larger index, say, 40. In addition, the index is a linear measure of interest rate risk, so that the illustrated institution is twice as risky as one with an index of 18.8 and only one-half as risky as one with an index of 74.8.

Table A-6. Balance Sheet at Market Value for a Hypothetical Savings and Loan Association After a Market Rate Increase of 100 Basis Points

(Dollar Amounts in Millions)

Assets	
Cash, Demand Deposits	$ 5.00
Treasury Securities	5.00
Residential Mortgages:	
5-year maturity	9.80
12-year maturity at 14%	23.00
12-year maturity at 10%	26.50
Other Loans	12.97
	$82.27
Liabilities	
Deposits and Savings Accounts:	
Passbook Accounts, 5.5%	$12.58
NOW Accounts, 5.25%	8.34
Super NOW Accounts, 11%	8.46
CDs, 1-year maturity, 6.5%	3.77
CDs, 2.5-year maturity, 6.75%	3.37
MMCs, 6-month maturity, 13%	12.94
MMCs, 6-month maturity, 12%	4.96
SSCs, 1.5-year maturity, 12%	8.38
Jumbo CDs, 13.5%	6.95
FHLB Advances, 13%	10.26
	80.01
Net Worth	2.26
	$82.27
Open Futures Contracts	
Treasury Bond	3.80
GNMA Security	2.94
	$ 6.74

Table A-7. Calculation of the Effective Interest Rate Sensitivity Index

1.	Change in the value of cash liabilities: (from Exhibits 3 and 4)	-$0.76
2.	Change in the value of cash assets: (from Exhibits 3 and 4)	-$2.73
3.	Change in value of open futures contracts:	$0.53
4.	Item 1 less the sum of items 2 and 3:	$1.44
5.	One plus the level of interest rates (10%) divided by 100 basis points (1.10/.01)	110
6.	Item 4, above, divided by market value of assets (1.27/85)	0.001694
7.	Interest rate risk index (Item 5 multiplied by Item 6)	+1.89 years
8.	Market value of total cash assets to net worth ratio (from Exhibit 3)	20.09
9.	Effective interest rate sensitivity index (Item 7 multiplied by Item 8)	37.4

APPENDIX B

REFERENCES

(637)

SECTION I. RESPONDING TO CRISES

Friedman, Milton, and Anna Jacobson Schwartz. 1963. A Monetary History of the United States, 1857-1960. Princeton, N.J.: Princeton University Press.

President's Commission on Financial Structure and Regulation. 1971. The Report of the President's Commission on Financial Structure and Regulation. Washington, D.C.: Government Printing Office.

U.S. Congress. 1976. Financial Institutions and the Nation's Economy. Compendium of papers prepared for the FINE Study, House Committee on Banking, Currency, and Housing, 94th Cong., 2d sess. (June).

SECTION II. REPLACING DIRECT CONTROLS

Beighley, Prescott II, John H. Boyd, and Donald P. Jacobs. 1975. Bank Equities and Investor Risk Perceptions: Some Entailments for Capital Adequacy Regulation. Journal of Bank Research 6 (Autumn).

Friedman, Milton, and Anna Jacobson Schwartz. 1963. A Monetary History of the United States, 1857-1960. Princeton, N.J.: Princeton University Press.

Golembe, Carter H. 1976. Memorandum re: Deposit Insurance Reform: Part I. Washington, D.C.: Carter, Golembe Associates.

Silverberg, Stanley C. 1980. Implications of Changes in the Effective Level of Deposit Insurance Coverage. Proceedings of a Conference on Bank Structure and Competition. Federal Reserve Bank of Chicago (May).

Winter, Robert, and Barbara Anderson. 1982. Deregulation Enlarges Bank Disclosure Obligations. Legal Times (November 29).

SECTION V. EXPANDING PRIVATE INSURANCE

Bergson, L. 1982. Investment Guarantee Cover Fizzles. Business Insurance (November 11).

Fields, Ernest W. 1969. Bankers Blanket Bonds: What They Cover and What They Do Not. Insurance Counsel Journal 27.

Keeton, Robert E. 1971. Basic Text on Insurance Law. St. Paul, Minn.: West Publishing Company.

SECTION VI. RETHINKING REGULATORY STRUCTURE

Benston, George J. 1975. Bank Examination. In Compendium of Major Issues in Bank Regulation. Senate Committee on Banking, Housing, and Urban Affairs. Washington, D.C.: Government Printing Office: 585.

Federal Deposit Insurance Corporation. 1982. Financial Statements: December 31, 1981. Washington, D.C.: Government Printing Office: 4.

Federal Home Loan Bank Board. 1982. 1981 Annual Report. Washington, D.C.: Government Printing Office: 93-94.

Hackley, Howard H. 1966. Our Baffling Banking System. Virginia Law Review 52, no. 4 (May): 598 ff.

National Credit Union Share Insurance Fund. 1982. Annual Financial Report, Fiscal Year 1981. Washington, D.C.: Government Printing Office: 23.

President's Commission on Financial Structure and Regulation. 1971. The Report of the President's Commission on Financial Structure and Regulation. Washington, D.C.: Government Printing Office.

Sheehan, John E. 1975. 1975--The Year for Federal Banking Reform. In Compendium of Major Issues in Bank Regulation. Senate Committee on Banking, Housing, and Urban Affairs. Washington, D.C.: Government Printing Office: 5.

Silverberg, Stanley C. 1976. Bank Supervision and Competitive Laxity. The Magazine of Bank Administrators 52 (January).

U.S. Congress. 1937. Investigation of Executive Agencies of the Government. Report prepared by the Brookings Institution for the Senate Select Committee to Investigate the Executive Agencies of the Government, 75th Cong., 1st sess.: 213-223.

____________. 1956. Reorganization Plan No. 2 of 1956. Hearings before the Subcommittee on Reorganization of the Senate Committee on Government Operations, 84th Cong., 2d sess. (June 27), test of plan: 4.

____________. 1963. Statement by Joseph P. McMurray at hearings before the Subcommittee on Bank Regulation and Insurance of the House Committee on Banking and Currency on H.R. 729, 88th Cong., 1st sess. (May 7).

____________. 1966. Investigation into Federally Insured Banks. Interim Report of the Senate Committee on Government Operations, Made by its Permanent Subcommittee on Investigations Together with Additional Views, 89th Cong., 2d sess. (April 13): 9-10.

____________. 1973. Financial Institutions: Reform and the Public Interest. Staff Report of the Subcommittee on Domestic Finance, House Committee on Banking and Currency, 93rd Cong., 2d sess. (August).

____________. 1976. Financial Institutions and the Nation's Economy. Compendium of papers prepared for the FINE Study, House Committee on Banking, Currency, and Housing, 94th Cong., 2d sess. (June).

____________. 1979. Consolidated Banking Regulation Act of 1979. Joint Hearings on S. 332 before the Senate Committee on Governmental Affairs and the Committee on Banking, Housing, and Urban Affairs, 96th Cong., 1st sess. (February 28 and May 15).

____________. 1982. Securities Activities of Depository Institutions. Hearings on S. 1720 before the Subcommittee on Securities, Senate Committee on Banking, Housing, and Urban Affairs, 97th Cong., 2d sess. (February 4, 9, and 12).

U.S. General Accounting Office. 1977. The Debate on the Structure of Federal Regulations of Banks. Washington, D.C.: Government Printing Office: 15-19.

Varvel, Walter A. 1976. FDIC Policy Toward Bank Failures. Economic Review 62, no. 5 (Sept.-Oct.): 10.

Whittlesey, Charles R. 1975. Examination and Supervision: Indications and Inferences. In *Compendium of Major Issues in Bank Regulation*. Senate Committee on Banking, Housing, and Urban Affairs. Washington, D.C.: Government Printing Office: 611.

APPENDIX A. INDEXES OF RISK

Federal Home Loan Bank Board. In press. Report of the Expanded Task Force on Current Value Accounting.

Hopewell, Michael H., and George G. Kaufman. 1973. Bond Price Volatility and Term to Maturity: A Generalized Respecification. *American Economic Review* 63: 749-53 (April).

Macaulay, Frederick R. 1938. *The Movements of Interest Rates, Bond Yields and Stock Prices in the United States Since 1856*. New York: National Bureau of Economic Research.

Redington, F. M. 1952. Review of the Principle of Life and Office Valuations. *Journal of the Institute of Actuaries* 78: 286-340.

APPENDIX C

BIBLIOGRAPHY

(643)

Altman, Edward I. "Predicting Performance in the Savings and Loan Industry." *Journal of Monetary Economics* 3 (October 1977): 443-66.

Altman, Edward I., and Sametz, Arnold W., eds. *Financial Crises: Institutions and Markets in a Fragile Environment*. New York: John Wiley and Sons, 1977.

Altman, Edward I.; Avery, Robert B.; Eisenbeis, Robert A.; and Sinkey, Joseph F., Jr. *Application of Classification Techniques in Business, Banking and Finance*. Greenwich, Conn. JAI Press Inc., 1981.

American Bankers Association. "Toward a More Viable Financial System." Recommendations of a Special Committee of the American Bankers Association Submitted to the Presidential Commission on Financial Structure and Regulation. Washington, D.C.: ABA, 1971: 93-103, 113-123.

Atkinson, Thomas R. *Trends in Corporate Bond Quality*. New York: Columbia University Press for National Bureau of Economic Research, 1967.

Barnett, Robert E.; Horvitz, Paul M.; and Silverberg, Stanley C. "Deposit Insurance: The Present System and Some Alternatives." *The Banking Law Journal* (April 1977).

Beaver, W. H. "Alternative Accounting Measures as Predictors of Failure." *The Accounting Review* 43 (January 1968): 113-22.

__________. "Market Prices, Financial Ratios, and the Prediction of Failure." *Journal of Accounting Research* 6 (Autumn 1968): 179-92.

Beighley, Prescott II; Boyd, John H.; and Jacobs, Donald P. "Bank Equities and Investor Risk Perceptions: Some Entailments for Capital Adequacy Regulation." *Journal of Bank Research* 6 (Autumn 1975).

Benston, George J. "Bank Examination." *The Bulletin of the Institute of Finance, Graduate School of Business Administration, New York University*, nos. 89-90 (May 1973): 1-73.

Benston, George J., and Marlin, John T. "Bank Examiners' Evaluation of Credit: An Analysis of the Usefulness of Substandard Loan Data." *Journal of Money, Credit and Banking* 4 (February 1974): 23-44.

Bergson, L. "Investment Guarantee Cover Fizzles." Business Insurance (November 1982).

Berry, Charles H. "Corporate Growth and Diversification." Journal of Law and Economics 14 (October 1971): 371-83.

Bierwag, G. O.; Kaufman, George G.; Schweitzer, Robert; and Toevs, Alden. "The Art of Risk Management in Bond Portfolios." Journal of Portfolio Management (Spring 1981): 27-36.

Bierwag, G. O.; Kaufman, George G.; and Toevs, Alden. "Management Strategies for Savings and Loan Associations to Reduce Interest Rate Risk." Proceedings of a Conference on New Sources of Capital for the Savings and Loan Industry. San Francisco: Federal Home Loan Bank of San Francisco (December 1979): 179-204.

Boyd, John H., Jr. "Federal Insurance of Savings and Loan Deposits: Analysis and Reform Proposals." A Study of FSLIC Risk Management in a Changing Economic and Regulatory Environment. Northwestern University, 1978.

Buser, Stephen A.; Chen, Andrew H.; and Kane, Edward J. "Federal Deposit Insurance, Regulatory Policy, and Optimal Bank Capital." Journal of Finance 36 (March 1981): 51-60.

Campbell, Tim S., and Dietrich, J. Kimball. "The Determinants of Default on Insured Conventional Residential Mortgage Loans." Working Paper, University of Southern California, September 1982. Mimeo.

Deakin, Edward B. "Business Failure Prediction: An Empirical Analysis." In Financial Crises: Institutions and Markets in a Fragile Environment. Edited by Edward I. Altman and Arnold W. Sametz. New York: John Wiley and Sons, 1977.

Deloitte, Haskins and Sells. "Asset Composition Net Worth Index." Washington, D.C.: Federal Home Loan Bank Board, 1980.

Domar, Evsey D., and Musgrave, Richard. "Proportional Income Taxation and Risk Taking." Quarterly Journal of Economics 58 (May 1944): 388-422.

Dothan, U., and Williams, J. "Banks, Agency, and Regulation." Working Paper, Kellogg Graduate School of Management, Northwestern University (October 1981). (Mimeo.)

Federal Deposit Insurance Corporation. *1981 Annual Report*. vol 1. Washington, D.C.

__________. *Financial Statements: December 31, 1981*. Washington, D.C.: Government Printing Office, 1982.

Federal Home Loan Bank Board. *1981 Annual Report*. Washington, D.C.: Government Printing Office, 1982.

__________. Report of the Expanded Task Force on Current Value Accounting. In press.

Fields, Ernest W. "Bankers Blanket Bonds: What They Cover and What They Do Not." *Insurance Counsel Journal* 27 (1969).

Fisher, L. "Determinants of Risk Premiums on Corporate Bonds." *Journal of Political Economy* 67 (June 1959): 217-37.

Flannery, Mark J. "Deposit Insurance Creates a Need for Bank Regulation." *Federal Reserve Bank of Philadelphia-Business Review* (January/February 1982): 17-27.

Flannery, Mark J., and Guttentag, Jack M. "Identifying Problem Banks." In *Proceedings of a Conference on Bank Structure and Competition*. Chicago: Federal Reserve Bank of Chicago (May 1979): 1-32.

__________. "Problem Banks: Examination, Identification and Supervision." In *State and Federal Regulation of Commercial Banks*. Leonard Lapidus and others, eds. Washington, D.C.: Federal Deposit Insurance Corporation, 1980: 171-226.

Fraine, Harold G., and Mills, Robert H. "Effect of Defaults and Credit Deterioration on Yields of Corporate Bonds." *Journal of Finance* 16 (September 1961): 423-34.

Friedman, Milton, and Schwartz, Anna Jacobson. *A Monetary History of the United States, 1867-1960*. Princeton, N.J.: Princeton University Press, 1963.

Glenn, David W. "Relative Cost Ratios for 42 FSLIC-Assisted Mergers." Unpublished.

Golembe, Carter H. "Memorandum re: Deposit Insurance Reform: Part I." Washington, D.C.: Carter, Golembe Associates, vol. 1976-8, 1976.

__________. "Memorandum re: Deposit Insurance Reform: Part II," Washington, D.C.: Carter, Golembe Associates, vol. 1977-4, 1977.

__________. "Our Remarkable Banking System." *Virginia Law Review* 53, no. 5: 1091.

Greenbaum, Stuart I. "A Study of Federal Insurance Reserve and Net Worth in the Savings and Loan Industry." *A Study of FSLIC Risk Management in a Changing Economic and Regulatory Environment*. Northwestern University, 1978.

Guttentag, Jack M. "Reflections on Bank Regulatory Structure and Large Bank Failures." U.S. Senate, Committee on Banking, Housing, and Urban Affairs, *Compendium of Major Issues in Bank Regulation*. 94th Congress, 1st Sess., August 1975.

Guttentag, Jack, and Herring, Richard. "Insolvency of Financial Institutions: Assessment and Regulatory Disposition." In *Crises in the Economic and Financial Structure*. Paul Wachtel, ed. Lexington, Mass.: Lexington Books, 1982.

Hackley, Howard H. "Our Baffling Banking System." *Virginia Law Review* 52, nos. 4 and 5 (May and June 1966): 565 and 771.

Hempel, George H. *The Postwar Quality of State and Local Debt*. New York: National Bureau of Economic Research, 1971.

Herzig-Marx, Chayim. "Comparing Market and Regulatory Assessments of Bank Condition." In *Proceedings of a Conference on Bank Structure and Competition*. Chicago: Federal Reserve Bank of Chicago, April 1977.

Hickman, W. Braddock. *Corporate Bond Quality and Investor Experience*. Princeton, N.J.: Princeton University Press for National Bureau of Economic Research, 1958.

Hopewell, Michael H., and Kaufman, George G. "Bond Price Volatility and Term to Maturity: A Generalized Respecification." *The American Economic Review* 63 (September 1973): 749-53.

Horvitz, Paul M. "Consolidation of the Regulatory Agency Structure: Has the Time for It Come?" *Economic Review*. Federal Reserve Bank of Atlanta (December 1982): 43-52.

__________. "Failures of Large Banks: Implications for Banking, Supervision and Deposit Insurance." *Journal of Financial and Quantitative Analysis* 10, no. 4 (November 1975): 589-601.

__________. "A Reconsideration of the Role of Bank Examination." Journal of Money, Credit and Banking 12 (November 1980): 654-59.

Horvitz, Paul M., and Pettit, R. Richardson. "Short-Run Financial Solutions for Troubled Thrift Institutions." In The Future of the Thrift Industry, Federal Reserve Bank of Boston, 1981. Series no. 24.

Kaufman, George G. "The Case for Mortgage Rate Insurance." Journal of Money, Credit and Banking 7 (November 1975): 515-519.

__________. "Measuring Risk and Return for Bonds: A New Approach." Journal of Bank Research 8 (Summer 1978): 82-90.

__________. "The Thrift Institution Problem Reconsidered." Journal of Bank Research 2 (Spring 1972): 26-33.

Keeton, Robert E. Basic Text on Insurance Law. St. Paul, Minn.: West Publishing Company, 1971.

Lapidus, Leonard et al., eds. State and Federal Regulation of Commercial Banks. Washington, D.C.: Federal Deposit Insurance Corporation, 1980.

Macaulay, Frederick R. The Movements of Interest Rates, Bond Yields and Stock Prices in the United States Since 1856. New York: National Bureau of Economic Research, 1938.

Maisel, Sherman J., ed. Risk and Capital Adequacy in Commercial Banks. Chicago: University of Chicago Press for the National Bureau of Economic Research, 1981.

Mayer, Thomas. "A Graduated Deposit Insurance Plan." Review of Economics and Statistics 47 (February 1965): 114-116.

McGrath, David A. Reform in Federal Bank Regulation and Supervision. New York: Federal Deposit Insurance Corporation, June 1977.

Merton, Robert C. "An Analytic Derivation of the Cost of Deposit Insurance Guarantees: An Application of Modern Option Pricing Theory." Journal of Banking and Finance 1 (June 1977): 3-11.

Modigliani, Franco, and Miller, Merton. "The Cost of Capital, Corporation Finance and the Theory of Investment." American Economic Review 48 (June 1958): 261-297.

Mullin, Robert A. "The National Bank Surveillance System." In Financial Crises: Institutions and Markets in a Fragile Environment. Edward I. Altman and Arnold W. Sametz, eds. New York: John Wiley and Sons, 1977.

Naslund, B. "Some Effects of Taxes on Risk Taking." Review of Economic Studies 36 (July 1968): 289-306.

National Credit Union Share Insurance Fund. Annual Financial Report, Fiscal Year 1981. Washington, D.C.: Government Printing Office, 1982.

O'Hara, Maureen. "A Study of Default Prevention." A Study of FSLIC Risk Management in a Changing Economic and Regulatory Environment. Northwestern University, 1978.

President's Commission on Financial Structure and Regulation. The Report of the President's Commission on Financial Structure and Regulation. Washington, D.C.: Government Printing Office, 1971.

President's Commission on Housing. The Report of the President's Commission on Housing. Washington, D.C.: Government Printing Office, 1982.

Redington, F. M. "Review of the Principle of Life and Office Valuations." Journal of the Institute of Actuaries 78 (1952): 286-340.

Roy, A. D. "Safety First and the Holding of Assets." Econometrica 20 (July 1952): 431-449.

Scott, Kenneth E., and Mayer, Thomas. "Risk and Regulation in Banking: Some Proposals for Federal Deposit Insurance Reform." Stanford Law Review 23 (May 1971): 857-902.

Securities Investor Protection Corporation. "SIPC: An Explanation of the Securities Investor Protection Act of 1970 as Amended Through 1980." Washington, D.C.: 1980.

Silverberg, Stanley C. "Bank Supervision and Competitive Laxity." The Magazine of Bank Administration 52, no. 1 (January 1976): 20-25.

__________. "Implications of Changes in the Effective Level of Deposit Insurance Coverage." Conference on Bank Structure and Competition. Federal Reserve Bank of Chicago (May 1980).

Silverberg, Stanley C., and Flechsig, T. "The Case for 100% Insurance on Demand Deposits." Issues in Bank Regulation. Bank Administration Institute (Winter 1978).

Sinkey, Joseph F., Jr. Problem and Failed Institutions in the Commercial Banking Industry. Greenwich, Conn.: JAI Press Inc., 1979.

Sinkey, J., Jr., "Early Warning System--Some Preliminary Predictions of Problem Commercial Banks." Proceedings of a Conference on Bank Structure and Competition. Federal Reserve Bank of Chicago, 1975.

Stiglitz, J. E. "The Effects of Income, Wealth, and Capital Gains Taxation on Risk Taking." Quarterly Journal of Economics 83 (May 1969): 263-283.

Stiglitz, J. E., and Weiss, Andrew. "Credit Rationing in Markets with Imperfect Information." The American Economic Review 71 (June 1981): 393-410.

U.S. Congress. Reorganization Plan No. 2 of 1956. Hearings before the Subcommittee on Reorganization of the Senate Committee on Government Operations. 84th Cong., 2d sess., 1956.

U.S. Congress. House. Committee on Banking and Currency. Hearings before the Subcommittee on Bank Regulation and Insurance on H.R. 729. 88th Cong., 1st sess., 1963.

__________. Consolidation of Bank Examining and Supervisory Functions, Hearings on H.R. 107 and H.R. 6885 before the Subcommittee on Bank Supervision and Insurance; April 12, 14, 28, 29, 30, June 29 and 30, 1965. 89th Cong., 1st sess., 1965.

__________. Financial Institutions: Reform and the Public Interest. Staff Report of the Subcommittee on Domestic Finance, August 1973. 93rd Cong., 2nd sess., 1973.

U.S. Congress. House. Committee on Banking, Currency, and Housing. Financial Institutions and the Nation's Economy. Compendium of papers prepared for the FINE Study. 94th Cong., 2nd sess., June 1976.

__________. Financial Institutions and the Nation's Economy (FINE) "Discussion Principles." Hearings before the Subcommittee on Financial Institutions Supervision, Regulation, and Insurance. 94th Cong., 1st and 2nd sess., December 1975, pts. 1-4.

U.S. Congress. Senate. Committee on Banking and Currency. FHLBB and FSLIC--A Study of Relationships. Washington, D.C.: Government Printing Office, 1956.

U.S. Congress. Senate. Committee on Banking, Housing, and Urban Affairs. Compendium of Major Issues in Bank Regulation. Washington, D.C.: Government Printing Office, 1975.

__________. Federal Bank Commission Act. Hearings on S. 2298. 94th Cong., 1st sess., October 31, December 1 and 8, 1975; 94th Cong., 2nd sess., February 2, March 1, 1976.

__________. Financial Institutions Act--1973. Hearings before the Subcommittee on Financial Institutions, May 13-17, 1974. 93rd Cong., 2nd sess., 1974.

__________. Financial Structure and Regulation. Hearings before the Subcommittee on Financial Institutions. November 6-8, 1973. 93rd Cong., 1st sess., 1974.

__________. Securities Activities of Depository Institutions. Hearings on S. 1720 before the Subcommittee on Securities, February 4, 9, 12, 1982. 97th Cong., 2d sess., 1982.

U.S. Congress. Senate. Committee on Governmental Affairs and the Committee on Banking, Housing, and Urban Affairs. Consolidated Banking Regulation Act of 1979. Joint Hearings on S. 332, February 28 and May 15, 1979. 96th Cong., 1st sess., 1979.

__________. Study on Federal Regulation. Prepared Pursuant to S. Res. 71. 95th Cong., 1st sess., 1977, vol. 5.

U.S. Congress. Senate. Committee on Government Operations. Investigation into Federally Insured Banks. Interim Report by the Permanent Subcommittee on Investigations Together with Additional Views. 89th Cong., 2nd sess., April 13, 1966.

U.S. Congress. Senate. Select Committee to Investigate the Executive Agencies of the Government. Investigation of Executive Agencies of the Government. Report prepared by the Brookings Institution. 75th Cong., 1st sess., 1937.

U.S. General Accounting Office. The Debate on the Structure of Federal Regulation of Banks. Washington, D.C., 1977.

________. Information on Consolidation of Bank Regulatory Activities. Washington, D.C., 1975.

Varvel, Walter A. "FDIC Policy Toward Bank Failures." Economic Review 62, no. 5 (September-October 1976): 3-12.

Wachtel, Paul, ed. Crises in the Economic and Financial Structure. Lexington, Mass.: Lexington Books, 1982.

Weinstock, David S. "Using the Herfindahl Index to Measure Concentration." The Antitrust Bulletin 27 (Summer 1982): 285-301.

West, Richard R. "Bond Ratings, Bond Yields and Financial Regulation: Some Findings." Journal of Law and Economics 16 (April 1973): 159-168.

West, Richard R. "An Alternative Approach to Predicting Corporate Bond Ratings." Journal of Accounting Research 8 (Spring 1970): 118-125.

Winter, Robert, and Barbara Anderson. "Deregulation Enlarges Bank Disclosure Obligations." Legal Times, Nov. 29, 1982.

Wood, John. "Information Needs for Monitoring Risk." A Study of FSLIC Risk Management in a Changing Economic and Regulatory Environment. Northwestern University, 1978.

APPENDIX D

BIOGRAPHIES

(655)

Peter M. Barnett is an Associate General Counsel and Director of the Policy and Projects Division of the Office of General Counsel at the Federal Home Loan Bank Board. The Policy and Projects Division has primary responsibility for legal issues arising under the FHLBB's regulations governing the extent of FSLIC coverage of accounts in insured institutions. Mr. Barnett is a member of the American Bar Association's Sections on Corporation, Banking and Business Law; and Real Property, Probate and Trust Law. He received his bachelor's degree from the University of Notre Dame and law degree from the University of Chicago.

H. Brent Beesley is Director of the Federal Savings and Loan Insurance Corporation. Prior to joining the Bank Board, Mr. Beesley served as Chairman of the Boards for Pioneer Bank, Community Bank and Trust, and West Home Bank, each of Salt Lake City, Utah. He was also a Partner with the law firm of Ray, Quinney & Nebeker in Salt Lake City. He taught real estate and business law at the University of Utah. Mr. Beesley is the owner of a large cattle ranch in Utah and has been active in real estate investment and development. He received a B.S. degree in economics and international relations from Brigham Young University in 1969 and M.B.A. and J.D. degrees from Harvard University in 1973.

Gerald O. Bierwag, a member of the Drafting Committee, is Professor of Finance and Economics at the University of Arizona. He has taught at the University of Oregon and has been a Visiting Professor at Warwick University in England. Mr. Bierwag is an Associate Editor of the Journal of Financial and Quantitative Analysis and a member of the Board of Editors of the American Economic Review and the Journal of Financial Research. He received a B.A. in economics from the University of Idaho and a Ph.D. in economics from Northwestern University.

Fischer Black, a member of the Drafting Committee, is Professor of Finance in the Alfred P. Sloan School of Management, Massachusetts Institute of Technology. He has taught at the University of Chicago and is the author of numerous articles on economic and financial issues. Dr. Black holds an A.B. in physics and a Ph.D. in applied mathematics from Harvard University.

R. Dan Brumbaugh, Jr. is a Visiting Scholar in the Office of Policy and Economic Research at the Federal Home Loan Bank Board. He has written extensively on issues in competition and the economic effects of government regulation. Previously, Mr. Brumbaugh was with the law firm of Wilmer, Cutler & Pickering in Washington, D.C. He received his B.A. degree from Colgate University and an M. Phil. in economics from the George Washington University, where he is currently completing his Ph.D. in economics.

John S. Buchanan is Executive Staff Director to the Chairman of the Federal Home Loan Bank Board. Mr. Buchanan is the Chief Operating Officer and is responsible for coordination and development of the operating policies and procedures for the Federal Home Loan Bank Board. Prior to joining the staff, he was Senior Vice President and Chief Administrative Officer at Imperial Savings and Loan Association in San Diego, California, a $3.6 billion institution. Previously, he held positions with the Federal Home Loan Bank of San Francisco, where he most recently served as Senior Vice President and Controller, in charge of the operations function. Prior to that he was with the Federal Home Loan Bank Board in Washington, D.C. He holds a B.B.A. in finance from the University of Iowa and an M.B.A. in finance from North Texas State University.

John L. Butler is Director of the Congressional Relations Office of the Federal Home Loan Bank Board. Mr. Butler is responsible for all Bank Board activities with the Congress, including planning and developing legislative initiatives and testimony. Prior to joining the Bank Board, Mr. Butler was on the staff of Representative Jim Leach (R-Iowa), and also on the minority staff of the House Committee on Banking, Finance, and Urban Affairs, where he specialized in international financial matters. He received a B.A. degree from St. Ambrose College and an M.A. from Johns Hopkins University School of Advanced International Studies.

Tim S. Campbell, a member of the Drafting Committee, is Associate Professor of Finance and Business Economics at the University of Southern California. He has taught at the University of Utah, and has served as an economist for the Board of Governors of the Federal Reserve. Mr. Campbell is author of several articles dealing with financial institutions, and *Financial Institutions, Markets and Economic Activities*, published by McGraw-Hill. He received his Ph.D. in economics from the University of California at Santa Barbara.

Andrew S. Carron, a member of the Drafting Committee, is a Senior Fellow in the Economic Studies Program at the Brookings Institution. Mr. Carron, who served as Senior Staff Assistant to the President's Commission on Housing, is a member of the Federal Savings and Loan Advisory Council. He is the author of *The Plight of the Thrift Institutions*, among other publications. He received a B.A. from Harvard University and a Ph.D. in economics from Yale University.

Henry J. Cassidy is Director of the General Research Division of the Office of Policy and Economic Research at the Federal Home Loan Bank Board, and is a professorial lecturer at Virginia Tech (Northern Virginia). Prior to joining the Bank Board, Mr. Cassidy was Senior Associate with Planning Research Corporation, and he has taught at George Mason University and George Washington University. He is the author of numerous articles and working papers on financial issues. Mr. Cassidy is currently Editor of the Housing Finance Review. He received his B.S. degree from Carroll College and M.A. in mathematical statistics and Ph.D. in economics from the University of Illinois.

Charlotte Appel Chamberlain is Director of the Office of Policy and Economic Research of the Federal Home Loan Bank Board. Ms. Chamberlain is responsible for providing economic analyses to the Bank Board on general economic developments, capital and mortgage markets, housing, the savings and loan industry, and competing financial intermediaries. Prior to joining the Bank Board, Ms. Chamberlain was Vice President and Department Manager for Glendale Federal Savings and Loan Association, Glendale, California. In this capacity, she was Glendale's Chief Economist and a member of the Investment Committee. Previously she was Chief of Forecasting and Modeling at the U.S. Department of Transportation. As a professor in the economics department at Northeastern University, she taught statistics, econometrics, and international trade. She holds a Ph.D. in economics from Cornell University.

D. James Croft is Director of the Office of Examinations and Supervision of the Federal Home Loan Bank Board. Mr. Croft is responsible for examining all savings and loans, resolving problems threatening the financial stability of individual savings and loans, and implementing civil rights and consumer affairs legislation affecting the industry. Previously, Mr. Croft was Director of the Office of District Banks at the Federal Home Loan Bank Board. Prior to joining the Bank Board, he was Professor of Management at the University of Utah's College of Business. Mr. Croft holds a bachelor's degree from Stanford University, and an M.B.A. and Ph.D. from Northwestern University.

Herbert W. Cummings, a Commentator, is Executive Vice President of Citizens Bank, Providence, Rhode Island. Citizens Bank has 30 branches in Rhode Island and $1 billion in assets. He has been Director of the American Bankers Association, Regional Director for the American Bankers Association Council, and President of the Rhode Island Bankers Association. He has been a member of the faculty of the National Association of Mutual Savings Banks; ABA, University of Oklahoma; and ABA, Stonier School of Banking. He is a member of the Executive Committee of the Rhode Island Bankers Association and the Advisory Board of the ABA, Stonier Graduate School of Banking. Mr. Cummings is a graduate of Fairleigh-Dickinson University and the Brown Graduate School of Savings Banking.

Gene Donovan, a Commentator, is Chairman of the Board and President of Prudential Financial Services Corporation and its wholly owned subsidiary Prudential Federal Savings, which are headquartered in Salt Lake City, Utah. The $700 million corporation has operations in Utah, Idaho, Montana, and Wyoming. Mr. Donovan has served as a member and Vice Chairman of the Board of Directors of the Federal Home Loan Bank of Seattle and as a member of the Advisory Council of the Federal Home Loan Bank Board. He has also been President and Director of the Utah Savings and Loan League, Director and Executive Committeeman of the National League of Savings and Loans, and President and Director of the Pacific Northwest Conference of Savings and Loans. He is a graduate of the University of Southern California, College of Engineering, and the Graduate School of Savings and Loan at Indiana University.

L. Malcolm Draper, Jr., is Assistant to the Chairman of the Federal Home Loan Bank Board. Mr. Draper serves as an advisor on policy matters and is responsible for management and coordination of the Offices of Communication and Congressional Relations. Prior to joining the Bank Board staff, he served as General Manager for Johnson, Pratt and Stewart Financial Consultants of Salt Lake City, Utah. He holds a B.S. degree in finance and an M.B.A. degree from the University of Utah.

Edward E. Edwards, a Commentator, is Professor Emeritus of Finance at Indiana University School of Business and Vice President of Business and Real Estate Trends Inc. Mr. Edwards has served as a director of the Federal Home Loan Bank of Indianapolis, a bank holding company, a commercial bank, two savings associations, and a federal credit union. He is currently a Consultant to the Chairman, Federal Home Loan Bank Board, and he has served as consultant to several government agencies and task forces, including the White House, the Secretary of Defense, the Federal Deposit Insurance Corporation, and the Commission on Financial Structure and Regulation. Mr. Edwards is the former editor of the MGIC Newsletter and author of numerous articles on the thrift industry, including "What Future for Savings Associations" and "Capital Adequacy Versus Insurance." He holds B.S and M.S. degrees from Indiana University.

Walter E. Erikson, a Commentator, is a Partner in the New York office of Peat, Marwick, Mitchell & Company and serves as the National Director of the firm's nationwide savings and loan practice. Peat, Marwick, Mitchell & Company is the largest professional accounting firm in the world based on 1982 billings; its savings and loan auditing practice is the largest in the United States with approximately 40 percent of the total savings and loan industry and more than 40 percent of the largest 300 savings and loan associations. Mr. Erickson is a member of the American Institute of Certified Public Accountants' Task Force on Relations with the Federal Home Loan Bank Board and Task Force on Forward Commitments and Interest Rate Futures, and he has served as a member of the Committee on Savings and Loan Associations. He has written extensively for national publications on accounting, financial, and management topics pertaining to savings and loan associations. He has served on the FHLBB Committee on Savings and Loan Industry Developments and is a member of the FHLBB Task Force on Current Value Reporting, the Financing Accounting Standards Board Advisory Committee on Futures Hedging, and the U.S. League of Savings Associations Task Force on Fresh Start Accounting. He is a Certified Public Accountant and is a graduate of Bentley College.

Bowers W. Espy is Deputy Director of the Office of Policy and Economic Research of the Federal Home Loan Bank Board. The Office of Policy Research is responsible for providing analyses and forecasting developments in financial markets, housing, the savings and loan industry, and other financial intermediaries for the Bank Board. Prior to joining the Bank Board, Mr. Espy was a financial economist with A.L. Fletcher and Associates, where he was consultant to California Federal Savings and Loan Association. He received his Ph.D. from the University of Florida.

James R. Faulstich, a Commentator, is President of the Federal Home Loan Bank of Seattle, which is the regional Federal Home Loan Bank for Alaska, Hawaii and Guam, Idaho, Montana, Oregon, Utah, Washington, and Wyoming. Mr. Faulstich has served as Director of the Oregon Department of Economic Development and before that he was Insurance Commissioner of Oregon, where he was principal author of the Oregon Insurance Code. He is Chairman of the Federal Home Loan Bank Presidents' Advances Pricing and Collateral Committee, and is a member of the Federal Home Loan Mortgage Corporation Advisory Committee and the Bank Presidents' Steering Committee. Previously, he was Vice President of the National Association of Independent Insurers, where he was responsible for legislative and regulatory liaison and policy development. He holds a bachelor's degree in business administration and finance from Indiana University and a J.D. degree from the University of Chicago Law School.

Anthony M. Frank, a Commentator, is Chairman, President, and Chief Executive Officer of First Nationwide Savings and Loan Association, San Francisco. First Nationwide Savings is one of the largest savings and loan associations in the United States with more than 140 offices in New York, Florida, and California, and assets of $7.2 billion. Mr. Frank is a Director of the Federal Home Loan Bank Board of San Francisco and Chairman of the Board and Director of the California Housing Finance Agency. Previously he was President of INA Properties Inc. and Group Vice President in charge of INA Properties Inc. and Group Vice President in charge of INA Corporation real estate and health care products. He holds a B.A. degree from Dartmouth College, an M.B.A. from Dartmouth's Tuck School of Business, and has done post graduate study in finance at the University of Vienna.

David W. Glenn is a member of the Drafting Committee. Mr. Glenn is Associate Professor and Chairman of the Department of Finance at the University of Utah. He has taught at the graduate schools of business at Harvard University, Stanford University, the University of North Carolina, and the University of California at Berkeley. He received a B.S. degree in business administration from Weber State College and an M.B.A. and Ph.D. in business from Stanford University.

Mary A. Grigsby, a Commentator, is Chairman of the Board of Houston First American Savings, Houston, Texas. Ms. Grigsby is a Director of the Federal Home Loan Bank of Little Rock and a Director of the U.S. League of Savings Institutions. She is a member of the Thrift Advisory Committee of the Federal Reserve Board, the Executive Committee of the U.S. League of Savings Institutions, the Legislative Policy Committee of the U.S. League of Savings Institutions, the Executive Committee of the National Savings and Loan League, and the Legislative Committee of the Texas Savings and Loan League. Ms. Grigsby serves as an advisor to the Texas Tech School for Savings and Loans and the College of Business Administration Development Council at Texas A & M University.

Jerry Hartzog served as Director of the Policy Analysis Division of the Office of Policy and Economic Research at the Federal Home Loan Bank Board during the preparation of this study. In that capacity, he was responsible for providing policy analyses for futures and options hedging, the Depository Institutions Deregulation Committee, and debt financing by savings and loans. Before joining the Bank Board, he was Associate Professor of Banking at the University of Tampa. Mr. Hartzog has published several articles on financial markets and institutions. He received his Ph.D. degree from the University of Alabama. He is currently Vice President for Corporate Policy and Planning at the Federal Home Loan Bank of San Francisco.

Charles W. Havens III, a Commentator, is a Partner in the law firm of LeBoeuf, Lamb, Leiby & MacRae, Washington, D.C., New York City, London, and other cities. Mr. Havens has been a very active writer, speaker, teacher, and advocate in the field of insurance and reinsurance law. Previously, he served as General Counsel and later President of the Reinsurance Association of America. Mr. Havens is a member of the bars of the District of Columbia and Virginia, the Supreme Court of the United States, and several U.S. circuit courts of appeals. He is a member of the American Bar Association, Torts and Insurance Practice Section; the Federation of Insurance Counsel; and the International Association of Insurance Counsel. He holds a bachelor's degree from Franklin and Marshall College and an LL.B. from the University of Virginia Law School.

Paul M. Horvitz, a member of the Drafting Committee, is Judge James J. Elkins Professor of Banking and Finance at the University of Houston. He has served as Senior Economist in the Office of the Comptroller of the Currency and as Director of Research and Assistant to the Chairman, Federal Deposit Insurance Corporation. Mr. Horvitz's publications include Monetary Policy and the Financial System and Management of Commercial Bank Funds. Mr. Horvitz holds a B.A. from the University of Chicago, an M.B.A. from Boston University, and a Ph.D. from the Massachusetts Institute of Technology.

James Jay Jackson is a Member of the Federal Home Loan Bank Board; he was appointed by President Reagan to be the Democratic Member, was confirmed on March 5, 1982, and reappointed to a four-year term in June 1982. Mr. Jackson is responsible for policy decisions affecting all aspects of regulating the savings and loan industry. Before coming to the Bank Board, he was Executive Vice President and Chief Operating Officer of Fidelity Savings and Loan Association, Port Arthur, Texas, and President of its subsidiary, First Mortgage Investors, Inc. Mr. Jackson was Co-Chairman of the National Energy Conference of the U.S. League of Savings Associations, and he has taught real estate investments and finance at Lamar University. He has served as President of the Greater Port Arthur Chamber of Commerce, and he has received several achievement awards including the Jaycees' Distinguished Service Award, Outstanding Young Man in America Award, and was chosen as one of Texas Magazine's "Rising Stars of Texas" of 1982. He received his bachelor's degree from Louisiana College.

Lois G. Jacobs is Assistant to Board Member Jackson of the Federal Home Loan Bank Board. She serves as aide and advisor on legal, economic, and policy matters that come before the Bank Board. Prior to her appointment as Mr. Jackson's Assistant, she was an attorney in the Office of General Counsel, first in the Regulations Division and later in the Business Transactions Division. Ms. Jacobs received a B.A. degree from Newcomb College of Tulane University and a J.D. from the University of Louisville School of Law.

George G. Kaufman, a member of the Drafting Committee, is the John F. Smith, Jr., Professor of Finance and Economics in the School of Business Administration at Loyola University of Chicago. Dr. Kaufman has served as Deputy to the Assistant Secretary for Economic Policy of the Department of the Treasury and as Senior Economist at the Federal Reserve Bank of Chicago. His publications include Money, the Financial System and the Economy and The U.S. Financial System: Money, Markets, and Institutions. He received a B.A. from Oberlin College, an M.A. from the University of Michigan, and a Ph.D. in economics from the University of Iowa.

Leon T. Kendall, a Commentator, is Chairman of the Board and Chief Executive Officer of Mortgage Guaranty Insurance Corporation, Milwaukee, Wisconsin, Vice Chairman of MGIC Investment Corporation, and a member of the Boards of Directors of both firms. Mortgage Guaranty Insurance Corporation is the nation's largest private mortgage insurer, with $51.7 billion insurance in force. It provides risk protection on one-to-four unit family residential properties in all 50 states. Total assets for 1982 were $873 million. Mr. Kendall is President of the Mortgage Insurance Companies of America and serves on the Advisory Board of the Federal Home Loan Mortgage Corporation. He is also a Director of the Federal Reserve Bank of Chicago and has served as President of the Securities Industry Association. He holds an M.B.A in marketing and a D.B.A in economics from the Indiana University School of Business.

Gerald J. Levy, a Commentator, is President of Guaranty Savings and Loan Association, Milwaukee, Wisconsin. Guaranty Savings and Loan has assets of nearly $200 million. It has focused on mortgage banking with the establishment of subsidiaries in California and Colorado. Its decision to remain a specialty operation since deregulation was primarily based on size considerations and the desire to concentrate on its areas of expertise. Mr. Levy has been a Director and Vice Chairman of the Federal Home Loan Bank of Chicago. He has served as Chairman of the Savings and Loan Review Board of Wisconsin, President of the Savings League of Wisconsin, Ltd., and member of the Wisconsin Legislative Council on Interest Rate Practice Committee. He is a member of the U.S. League of Savings Associations Executive Committee. He received B.S. and J.D. degrees from Northwestern University.

Paul T. Peterson is a Financial Economist with the Office of Policy and Economic Research at the Federal Home Loan Bank Board. He has provided economic analysis for a number of special projects since joining the Bank Board. Previously, he was a visiting Assistant Professor of Finance and Real Estate at the University of Utah, and prior to that he was Assistant Professor of Real Estate at Arizona State University. Mr. Peterson has conducted extensive research in the areas of real estate and mortgage financing and has served as a consultant to companies and associations in the real estate field. He received his B.S. degree from Brigham Young University, and M.B.A. and Ph.D. in business administration from the University of Utah.

Richard L. Petrocci is Director of Administration at the Federal Home Loan Bank Board. As Director of Administration, Mr. Petrocci develops administrative plans and is responsible for programs and policies in administrative services, information systems, building management, and financial management. He has been with the Bank Board since 1965 and has held various positions including Director of Information Systems Division. He attended Lemoyne College in Syracuse, New York.

Richard T. Pratt is Chairman of the Federal Home Loan Bank Board. He was appointed to the post by President Reagan on April 13, 1981. Prior to his appointment, he was President of Richard T. Pratt Associates, Inc., and a partner with the firm of Johnson, Pratt and Stewart Financial Consultants in Salt Lake City, Utah. Both firms engage in the development of housing finance systems and programs of increased profitability for financial institutions. Additionally, Mr. Pratt taught at the University of Utah Graduate School of Business and has also taught corporate finance for the University of Utah under special M.B.A. programs in England, Germany, Greece, and Spain. He has been a Public Interest Director and member of the Executive Committee of the Federal Home Bank of Seattle. He has consulted for the Federal Home Loan Bank Board, the Federal Home Loan Mortgage Corporation, the Mortgage Guarantee Insurance Corporation, and the U.S. State Department Agency for International Development. Mr. Pratt holds B.S. and M.B.A. degrees from the University of Utah and a D.B.A. degree from Indiana University.

Lewis S. Ranieri, a Commentator, is a Managing Director of Salomon Brothers Inc, New York. Salomon Brothers Inc is an international investment banking, market making, and research firm with offices in the United States and abroad. Their purchases and sales of securities, denominated in 13 currencies, was $1.65 trillion in 1982. Salomon Brothers Inc trading volume of 22 different types of mortgage securities exceeded $100 billion in 1982. Mr. Ranieri is responsible for the firm's activities in the mortgage, real estate, and government guaranteed areas. Prior to assuming his present position in mortgage trading activities, he was senior corporate bond trader specializing in utilities. He has been with Salomon Brothers since attending college and previously served as Vice President and General Partner. He received his B.A. from St. John's University.

Gilbert G. Roessner, a Commentator, is Chairman and Chief Executive Officer of City Federal Savings and Loan Association, Elizabeth, New Jersey. City Federal Savings is a $4.6 billion diversified financial services company with 98 full-service banking offices in New Jersey and Florida, and 93 additional mortgage and consumer lending subsidiary offices in 17 states nationwide. Mr. Roessner is a Director of the Federal Home Loan Bank of New York. He has been President of the National Savings and Loan League and served as a member of President Reagan's Housing Policy Task Force. He is a graduate of Rutgers University in business administration, the American Savings and Loan Institute, and the International School, the Building Societies Institute, Oxford, England.

Michael D. Schley is an Attorney-Advisor with the Policy and Projects Division of the Office of the General Counsel at the Federal Home Loan Bank Board. Mr. Schley has worked extensively on the development of risk criteria for the assessment of FSLIC premiums. He holds a bachelor's degree from Westmont College and J.D. degree from the University of California, Hastings College of the Law.

Stephen P. Terry is Director of the Federal Home Loan Bank Board Office of Finance. Mr. Terry is responsible for the financial planning, debt issuance, and liquidity management of the Federal Home Loan Bank System and is its fiscal agent. Previously, he served as Director of the Office of District Banks at the FHLBB. Prior to joining the Bank Board, Mr. Terry was President of Stephen P. Terry & Associates, a mortgage brokerage and consulting firm, in Salt Lake City, Utah. Before opening his firm, Mr. Terry was Executive Vice President for Funds Management at Prudential Federal Savings and Loan Association in Salt Lake City. He is a graduate of Brigham Young University and the Graduate School of Savings and Loans at Indiana University.

Thomas P. Vartanian is General Counsel of the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation. The Office of General Counsel provides legal counsel to and represents the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation. Previously, Mr. Vartanian was with the Washington, D.C., law firm of Howrey & Simon. Before that, he was senior antitrust counsel in charge of merger litigation and Special Assistant to the Chief Counsel for the Office of the Comptroller of the Currency. He holds a bachelor's degree from Cathedral College and a law degree from Brooklyn Law School.

APPENDIX E

FEDERAL HOME LOAN BANK BOARD

MASTHEAD

(671)

FEDERAL HOME LOAN BANK BOARD

Chairman

Richard T. Pratt

Board Member

Jamie Jay Jackson

Executive Staff Director

John S. Buchanan

Assistants to Board Members

L. Malcolm Draper Jr.
Assistant to the Chairman

Lois G. Jacobs
Assistant to Board Member Jackson

Office Directors

Charlotte A. Chamberlain
Office of Policy and Economic Research

Stephen P. Terry
Office of Finance

H. Brent Beesley
Federal Savings and Loan
Insurance Corporation

D. James Croft
Examination and Supervision

Thomas P. Vartanian
General Counsel

ADMINISTRATIVE STAFF

Administration

Richard L. Petrocci
William Schilling
Jeffrey R. Morrow

Support Staff

Marie George
Florence Phillips
Diane Pirko

NATIONAL CREDIT UNION ADMINISTRATION
WASHINGTON, D.C. 20456

April 15, 1983

Honorable Jake Garn
Chairman
Committee on Banking, Housing, and
Urban Affairs
U. S. Senate
Washington, D. C. 20510

Dear Mr. Chairman:

The enclosed Report is forwarded in accordance with the provisions of Section 712 of P.L. 97-320.

In preparing for this Report, we came to realize that for credit unions there were some very clear answers to the issues raised by Congress. This is because credit unions, unlike the other federally insured institutions, have actual experience with the options and alternatives suggested by the items to be studied. Therefore this Report is based primarily on the letters and comments which were requested by NCUA from credit union leaders, state regulators, private insurance corporations, and credit union trade associations. Our responses are based on historical facts and current operational realities rather than academic theories or untried options. The credit union experience with insurance has been substantially different from the other agencies and our recommendations accordingly reflect this unique heritage. Nevertheless, the Report does recognize that federally insured institutions instilled and maintain an important measure of confidence in our overall financial system. As such, federal insurance continues to play an important role.

Federal credit unions operated from 1934-1970 without any federal deposit insurance. In fact, credit union associations actively opposed federal insurance for over 20 years as incompatible with cooperative principles. Instead, they developed private stabilization alternatives. The 36 years without insurance and the 12 years with insurance reveal no dramatic differences in financial or economic trends. Rather, the entire period shows a continuing evolution of credit unions as an increasingly united system of financial cooperatives. However federal insurance did tend to displace local and private efforts at problem resolution. There are repeated observations from respondents that as the NCUSIF took over the activities of liquidations, the underwriting of mergers, and the extension of stabilization assistance, the sense of responsibility for problem solving by members, managers, directors, and leagues was correspondingly reduced. Insurance has tended to replace the cooperative sharing of risk by members.

During the extended period without federal insurance, many private share insurance or guarantee funds were developed at the state level. Today some 16 funds insure over 3,150 credit unions with total shares in excess of $12.3 billion. These programs have a variety of capital structures, assessment practices, coverage limits, and operational methods for monitoring risk and solving problems. These private funds are offering an alternative insurance program to state chartered credit unions in 34 states and represent a unique factor in the credit union financial system.

NATIONAL CREDIT UNION ADMINISTRATION
WASHINGTON, D.C. 20456

This report, in addition to addressing each issue raised by the Congress, makes three major recommendations for the Fund and takes a strong position on the question of consolidation.

1. Federal credit unions should have a choice for Share Insurance. While insurance should remain a requirement for all Federal charters, individual Federal credit unions should be offered a choice. We believe this change is necessary for a vital and responsive system of credit union share insurance. We maintain that risk rating of government share insurance is theoretically and practically inconsistent with government's role as an "insurer of last resort." Risk rating can best be done by the private sector. The 16 private funds now using a variety of funding and premium assessment stategies are examples of the creativity brought to this activity by private insurance.

2. Capitalize the NCUA Fund by a one time 1% assessment of insured shares. These funds would augment those available for losses and would be maintained for the duration of participation in the Fund. The NCUA, unlike the FDIC and FSLIC, received no government funds for capital. The Fund has been building entirely from credit union premiums while simultaneously meeting payout commitments. We believe that this approach to capitalization would be more effective than the piecemeal annual additional assessments currently being used and would give the industry the unquestioned ability to plan and control its own destiny.

3. At least one share of each NCUA insured account should be uninsured. This change would allow members to participate cooperatively in the risks of the credit union, would immediately add to each credit union's available equity base, and would recreate, we believe, a greater sense of responsibility for the credit union among members. The $100,000 coverage now in effect is satisfactory, however there is a need to consider a limited modification to the current flat rate premium system to incorporate tiered pricing for larger balance accounts. Private insurance should continue to be available for all "excess insurance" needs or special situations which credit unions may individually want to insure above $100,000.

NCUA is strongly opposed to consolidation of the NCUA insurance fund. We believe this action would destroy the uniquely responsive credit union insurance programs and activities, and create a new federal regulatory structure which would lead inexorably to an homogenization of all financial institutions and a reduction of competition in the financial marketplace. Credit unions would be the first to be squeezed out.

We believe these recommendations are not only in credit unions' interests but will benefit the general public. The public's participation in credit unions through over 45 million accounts is proof that credit unions are a viable and competitive force in today's economy.

At a time in our economic fortunes when major decisions are increasingly centralized in the hands of a small number of large governmental organizations or large private companies and banks and the results are not satisfactory, credit unions offer a real alternative. Self-help efforts at the grass roots is where individuals and groups turn when government or big private organizations fail to meet their needs.

NATIONAL CREDIT UNION ADMINISTRATION
WASHINGTON, D.C. 20456

Credit unions are just such organizations. There are over 20,000 credit unions with a minimum of 140,000 directors and countless other volunteers with their fingers on the pulse of local needs. In a turbulent environment when unanticipated events happen which an institution,no matter how large, could not possibly foresee or control, credit unions offer a system of organizations in which decision-making gets closest to the people who are affected. Further, these individual organizations are also capable of coordinating action for a collective response.

We believe that when the delivery systems of major government agencies and private organizations are found wanting, credit unions are an authentic, democratic alternative which can revitalize segments of our society. The need for credit unions isn't just their role as financial cooperatives, but more importantly, as an example that individual efforts at a local level can succeed in giving people some control of their economic destiny. These examples give us renewed confidence in our future by reminding us that each individual can indeed make a difference.

Sincerely,

E.F. Callahan

E. F. CALLAHAN
Chairman

CREDIT UNION SHARE INSURANCE

A REPORT TO THE CONGRESS

Prepared by: The National Credit Union Administration
Washington, D. C.
April 15, 1983

TABLE OF CONTENTS

TAB

1. Impact of Insurance on Credit Unions

   Exhibits: "Why Share Insurance is Unnecessary and Undesirable" — A Pamphlet

   "Credit Union Independent; Folks Like it that Way" Oklahoma World, March 5, 1983

   Listing of Private Share Insurance Corporations

2. Feasibility of Providing Additional Insurance

   Exhibit: Membership Share Proposal

3. Risk Rating

4. Expanding Insurance Coverage and the Increase of Risk

5. Revisions to Current System

6. Public Disclosure

   Exhibits: Example of Standard Monthly Disclosure Form
   Sample Financial Performance Report

7. Consolidation of the Three Federal Insurance Funds

Appendix

— NCUA Questionnaire Used in Study

— List of Contributors

Enclosure: 1982 Annual Report of the National Credit Union Administration Share Insurance Fund

Item 1

The current system of deposit insurance and its impact on the structure and operations of depository institutions.

Federal insurance of credit union shares was not passed by Congress until October 1970 which was 36 years after the passage of the Federal Credit Union Act. This relative newness of credit union share insurance compared to the 50 years of history of the FDIC and FSLIC has caused NCUA insurance to have a much different level of operational activity and has given credit unions the opportunity to develop a number of significant non-federal share insurance options. To assess the impact of Federal share insurance on credit unions, it is useful to understand why credit union Federal insurance was passed so much later than the original Act.

Origins of Federal Insurance

Federal deposit insurance was provided by the Banking Act of 1933. This was passed in an economic environment which had seen 12,115 or 40 percent of the nation's banks fail from 1921 to 1933. Upon Roosevelt's inauguration in 1933, a banking holiday was declared in all states and the Emergency Banking Act was passed on March 9 to identify those banks which were in good condition and to allow them to reopen. The nation was in a depression and the government had to act decisively to maintain public confidence in the nation's banking system.

Congressman Rankin, in the House debate, compared the nation's worry about its economic condition to the concerns of a country after a major national disaster:

> Charles Darwin, the greatest scientist, in his Voyage of the Beagle, tells of being in South America in 1835, when that country was visited by a series of terrific earthquake shocks that lasted for many days and shook the Andes Mountains from Patagonia to Panama. He said that for days and months and possibly years after the visitation of that great catastrophe everyone in South America seemed doubtful even of the ground on which he stood. His confidence was so shaken in the stability of the universe that he even walked with fear and trembling. He did not regard the ground as that "sure and firm-set earth" to which another great writer once referred.
>
> Mr. Speaker, we have passed through the greatest economic catastrophe in history. Never in the history of mankind has the confidence of the people been so disturbed as it has in the past 3 1/2 years. Never have they had so little faith in our economic institutions. Nothing we can acomplish will do more to restore that confidence and stabilize conditions than the passage of this law to guarantee bank deposits. For that reason I say it would have been a crime—and I mean a crime—for this Congress to adjourn without passing some kind of a law to guarantee these deposits, restore the confidence of the American people, and help to stablize our economic structure, in order to take advantage of and get the benefits of the legislation that has already been passed and the reforms that have already been brought about.

Congressman Smith speaking in the House on March 9 on the Banking Emergency Relief Act also identified this same need:

> Mr. Speaker, we must have a Federal guaranty of bank deposits law, so that the savings of our citizens and the money of our merchants and business men in all the communities of our land will be safe and secure. Not until such a Federal statute is passed and in force will complete confidence in our banking system be restored, nor the funds of the American people be placed on deposit in banks and enable the bankers to make loans to refinance the transactions of business and industry in this country.

S&L's Ask For Insurance Parity with Banks

While the Savings and Loan industry had not been as severely affected as the banking industry by the depression, nonetheless in the early 1930's approximately 1,700 institutions failed causing losses of more than $200 million to depositors. Thus the passage of Federal deposit insurance for banks immediately created a need for comparable legislation for the Savings and Loan industry.

Congressman Reilly stated the argument as follows:

> This law has been made necessary by the insuring of bank deposits in this country up to $2,500 and, after July 1 next, up to $5,000. Notwithstanding the fact that these mutual institutions have a remarkable record for solvency and have stood up in many ways better than the banks, yet it would appear that the people are putting their money in banks instead of these cooperative home-building institutions, and the object of this legislation is to make the savings of the people, that may be put in these home-building institutions, just as safe as if they were placed in banks of the country.

Chairman John H. Fahey of the FHHLB described the situation in a letter to Senator Fletcher on May 11, 1934 as follows:

> The advent of deposit insurance for banks has resulted in a substantial deflection of wage earner's savings from investment in building and loan associations to deposit in banks where they will be insured. Not only principles of fair treatment but the economic necessity of keeping funds from flowing out of institutions where they are needed and into institutions where they will presently be unused calls for the erection of a system of insurance for building and loan associations comparable to that in operation for the protection of bank depositors.

Credit Unions Succeed in Depression without Insurance

In this same year 1934, the Federal Credit Union Act was passed. But the history of credit unions chartered under the 38 state laws passed since 1909 was entirely different from banks and S&Ls. Not only was there an absence of institutional failure and member losses, but also credit unions were seen as a "self help" solution to the economic, financial, and confidence problems facing the ordinary citizen. Not once during the debate was there a request for or a need cited justifying share insurance. In fact credit unions were discussed as examples of financial stability and strength.

Rep. Wright Patman (D-Texas) during debate, Congressional Record June 16, 1934:

> I think the greatest service I can pay to those in charge of the baby banks (Patman's term for credit unions) is that during the Depression not a one of them failed.

Senator Sheppard (D-Texas) during debate, Congressional Record April 24, 1934:

> Composed of working people, intensely stricken by the depression, the credit unions have came through with no involuntary liquidations, esablishing in the process a very extraordinary record.

Rep. Steagall, Chairman, House Banking Committee, during debate on Federal Credit Union Act June 16, 1934:

> They have served their members satisfactorily and successfully. During the entire period of the depression these institutions have been able to carry on to the satisfaction of their members without loss and without difficulty.

> This system of institutions will fill a most desirable need in the credit union world of a class of people who have suffered from exorbitant and unjustifiable interest rates.

Senate Report 73-55 - To establish a Federal Credit Union System, March 20, 1934:

> Credit unions now operate under the same form of examination as State banks. They are composed of average working people who have been hard hit by the depression; they develop from within their own capacity for management. In the 38 States and in the District of Columbia there have been no involuntary liquidations of credit unions. Their record for honest management is exceptional. Eligible for relief from the Reconstruction Finance Corporation, less than a dozen of them have sought any relief. They have proved their durability and they have served their members uninterruptedly during the worst depression in our history. They are capable of rapid mass development as they have to deal with problems which affect the masses of the people.

Why Credit Union Share Insurance is Different.

From 1934 to 1970 federal credit unions operated without share insurance. The historical, operational and organizational differences in NCUA Share Insurance when compared with FDIC and FSLIC arise from the fact that credit unions are a different kind of financial institution. Credit unions are financial cooperatives. They are organized with no equity; financial reserves are set aside only from retained earnings. Human capital, the mutual sharing of risks, and sponsor support substitute for the financial capital used to start other financial institutions.

Because of this, credit unions generally have a much different relationship with their members than exists between other financial institutions and their customers. This credit union spirit arises in part from the common bond or field of membership. It also stems from an idealism and independent character that motivates the organization of a credit union as the financial intermediary for a designated group. This same spirit also created intense debate and opposition to share insurance proposals as contrary to the true character of a credit union. As stated in 1959 in one of the movement's discussions of share insurance:

> One of the fundamentals of the credit union movement has been faith in the individual — I believe that the average man is honest and will treat his fellows honestly. The idea of a stabilization insurance program is at variance to such idealism for when the faith is transferred from the credit union and its members to a statewide, national or international share insurance corporation and share insurance replaces moral integrity, we will have lost one of our fundamental sources of strength. (CUNA Minutes — 1959)

Credit Unions Oppose Federal Insurance

During the 36 year period that FCU's operated without Federal insurance coverage, it was never actively sought by the leaders of the industry. Even though credit unions were under the FDIC's administration from 1942-1948, there were no efforts to request insurance. In the early 1950's when the subject began to be discussed, the initiative to provide federal insurance to all institutions came from President Eisenhower's administration in 1955 and 1956 and was strongly opposed by the credit union industry. The reasons for opposition were numerous:

- It was opposed as "adding to the cost of the credit union's operations" and introducing another Agency to regulate or otherwise dictate the terms for a credit union operation.

- It was demonstrably not needed - indeed the Bureau of Federal Credit Unions did a study of all liquidations from 1934-1952 and found 80 percent of the liquidated credit unions distributed 100 percent or more to members; the 390 credit unions that distributed less than 100 percent had a prorated average loss per member of $3.84.

- Federal insurance would not get at the basic causes of losses and would reduce the incentive of supervisory or audit committees to properly perform their duties.

- There were also fears that federal share insurance would reduce the number of credit unions in operation, put an end to new charters, and introduce a "federalization" of the dual chartering system.

Although this lack of insurance was pointed to by the competition, there was no change in the public opposition of the major national credit union trade associations. Rather the Credit Union National Association (CUNA) initiated a study of four alternative methods of managing problem credit unions - three in the U. S. and one in Canada rather than to pursue Federal share insurance legislation. Credit Unions in Wisconsin developed a system built around the state central credit union which facilitated liquidations by purchase of assets; an Illinois plan was created based on a private profit making credit union owned state chartered share insurance corporation; a Michigan Stabilization plan was begun using a fund built from League dues, and a Saskatchewan deposit insurance corporation was based on a provincial Statute. Out of these efforts, a private country-wide stabilization program was begun in 1959 and 1960 under the umbrella of the International Stabilization Fund of CUNA. Two examples of this independent spirit are at the end of this section. One is a pamphlet from 1954 opposing share insurance subtitled "freedom vs bondage" and the second a recent newspaper article about the Muskogee District Telco Credit Union which wants to remain uninsured.

Federal Insurance Arrives when Credit Unions are in "Their Strongest Financial Condition in History"

The issue of Federal insurance was ultimately brought to the legislative arena by a new credit union trade association formed primarily over the issue of seeking Federal share insurance for credit unions. This group was called the National Association of Federal Credit Unions (NAFCU). Together, in 1971, CUNA and NAFCU were able to compromise on a common bill for federal insurance which received Congressional approval. The setting, the "need," and the Congressional motivation were radically different, however, than the environment that led to the creation of the FDIC & FSLIC.

Congress didn't feel that insurance was needed, rather it wanted to reward credit unions for a job well done and provide parity in insurance with other financial institutions. As stated in the Patman Committee's report in the bill:

> Credit unions are the only federally chartered financial institutions that do not have a Federal program of savings or deposit insurance. Despite the lack of insurance credit unions have grown to a point where there are now more credit unions than all financial institutions combined. Despite this remarkable and rapid growth, credit unions have maintained an outstanding record of safeguarding member shares. Your committee wishes to make clear that this legislation is designed solely to give credit unions the same insurance afforded other federally chartered financial institutions and should be considered as a reward for the outstanding job performed by credit unions. The legislation in no way is intended to indicate that credit unions are facing a period of monetary difficult. On the contrary, your committee feels that credit unions are in perhaps their strongest financial condition in history.

Current System has both Federal and Private Insurance

As credit unions debated and experimented with different kinds of external guarantees or insurance support for problem institutions, it was at the State level that the first successful programs were begun.

Share insurance was first authorized, but never implemented, in 1940 in New York State. In 1956, Illinois started the first private corporation under special legislation. The first state sponsored program was begun in 1961 in Massachusetts when the Massachusetts credit union share insurance corporation was incorporated and began insuring shares on a voluntary basis. It remains in existence today and is the largest of the 16 state credit union share insurance corporations. In 1967, the North Carolina Savings Guaranty Corporation was started — to be followed by the Wisconsin and Rhode Island Share Insurance Corporation, both in 1970.

At year end, over $12.5 billion credit union shares in 3,150 credit unions were privately insured through 16 different state chartered corporations.

Before and After Federal Share Insurance

Because credit union share insurance coverage is relatively recent compared to FDIC and FSLIC and has been extended to a siginificant portion of credit unions for only the past 10 years, one of the ways of assessing the impact of share insurance is to compare the 36 years of Federal credit union history without insurance with the 12 years of coverage to identify significant differences, if any.

Changes in Number of Credit Unions

The decade of federal share insurance from 1971-1980 is characterized by a sudden slowdown in the number of new charters issued and an increase in charters cancelled compared to the decades without federal insurance. These trends continue in 1981 and 1982 as well.

Federal Credit Union Trends
(1934-1982)

Period	Charter Cancellations	New Charters	Ratio Cancel/New Charters
1934-40	325	4,210	8%
1941-50	1593	2,836	56%
1951-60	1807	7,053	26%
1961-70	3144	6,325	50%
1971-80*	4063	3,310	123%
1981*	554	119	465%
1982*	556	114	488%

*NCUA Insurance in effect

While the causes of the trends aren't due solely to the influence of federal share insurance, (for example changing economic conditions and changing Agency programs and policy) there are a number of commentators who suggest that federal insurance did "push" events so as to accelerate these outcomes.

Prior to the advent of share insurance credit unions were forced to adhere to a relatively conservative operational mode and as a result their services were limited. A by-product of this situation was the minimization of risks. During that period growth was slow but steady.

In the event of liquidation the stabilization fund would immediately pay off all shareholders dollar for dollar, and then it would try to collect outstanding loans. The stabilization fund was also used to shore up credit unions in trouble and it saved many credit unions from certain liquidation. While many members probably did not know about the stabilization fund, they had confidence in the credit union as a cooperative.

As a League Consultant during the 1960's, I can state unequivocally that the lack of share insurance was not a problem for credit unions. (New York Credit Union League)

The 36 year period of federal credit union history prior to deposit insurance (even longer for some states) would reflect strong and stable growth for credit unions Credit unions were operated in a consistently safe manner and rarely were there any member losses in a credit union during that period. Credit unions would help other credit unons that were new or just developing by offering low cost loans. Also, stabilization programs were developed in most of the states to help credit unions over short-term or insurmountable problems... . When a liquidation did occur, league stabilization programs helped the credit union to distribute the share dollars at their full value. (California Credit Union League)

The question is raised as to whether or not the lack of deposit insurance did have an effect on credit union safety and soundness, as well as member losses. It did require the examiners and supervisory personnel, as well as the management of credit unions to be continually aware of the impact of policy decisions on credit union solvency, and I think the degree of supervision was perhaps a little more strict in those days, than is probably true today, primarily because of the psychological impact of share insurance. To some extent, this has caused, in my opinion, an attitude that the taxpayers are picking up the tab, and there is generally more of a lackadaisical attitude on the part of credit union officials and management, whether or not that position is justified. In my estimation it clearly is not warranted

Many of the liquidations were completed and shareholders received 100% of their savings, and in a number of instances received a premium as a result of the existence of sizeable dollar balances in Reserves and Undivided Earnings. My general feeling is, in looking back at the period prior to share insurance, that

> credit unions tended to be more concerned about the operations of other credit unions than perhaps they do today. They recognize that the failure of a credit union, particularly where this became a matter of public record through newspaper articles, they could stand to suffer. There were a number of instances where companies or sponsoring groups also provided financial assistance to credit unions to stem certain financial difficulties that does not take place today. (Ohio Credit Union League)

> Problems were solved without insurance simply by paying less dividends when necessary or no dividends when necessary and simply by the fact that these problems were not as severe because most of the credit unions were in a closed charter type situation and a very close knit relationship which minimized their loss problems. As far as the role of league stabilization funds in the early period, it was a primary project of the leagues to help stabilize credit unions, to keep them from becoming insolvent, and thereby also giving the leagues an opportunity to work with problem credit unions. It was an effective tool of the league at a time when only small amounts of money were required. Now, at this point, league stabilization funds are difficult to amass in amounts which would be helpful to bale out credit unions. (North Dakota League)

Impact on FCU Membership

In the same decade to decade comparison, there does not appear to have been any major change in the growth of member accounts in the pre and post insurance periods.

Growth in Membership of Natural Person
Federal Credit Unions
Selected Periods — 1934-1982

Period	Compounded Annual Average % Change in Members	Number of Members at End of Each Period
1934-40	+130.7%	1,217,940
1941-50	+4.2%	2,126,823
1951-60	+11.1%	6,087,378
1961-70	+7.0%	11,966,181
1971-80*	+7.4%	24,519,087
1981*	+3.8%	25,459,059
1982*	+2.4%	26,081,005

*NCUA Insurance in effect

Changes in Share Growth

The post insurance decade does show an increase in the average annual rate of share growth compared to the decade just prior to share inssurance. While share insurance undoubtedly did increase member confidence and give credit unions competitive equality with banks and S&Ls in the area of insurance, a number of economists suggest that the more rapid growth of savings at all financial institutions in the decade of the 1970's was primarily due to the more inflationary growth of GNP and the rise of the underlying monetary base as compared to the 1960's.

Growth in Total Savings at Natural Person
Federal Credit Unions
Selected Periods — 1934-1982

Period	%Annual Compound Growth in Savings	Total Savings at End of Decade or Year
1934-40	+21.2%	$65,806
1941-50	+18.6%	$361,925
1951-60	+20.5%	$2,344,337
1961-70	+12.5%	$7,628,,805
1971-80*	+16.8%	$36,263,343
1981*	+3.9%	$33,934,501
1982*	+17.2%	$41,313,824

NCUA Insurance in effect

In comments received on the impact of share insurance on individual member limits, there is repeated mention that members probably increased the total shares above the $2,000 life insurance limit once federal insurance came into effect. Free life insurance in an amount equal to a members' savings up to $2,000 maximum is one of the traditional benefits offered by credit unions to attract savings. This increase in the larger savings acount balances during the 11 years of deposit insurance is shown in the chart below:

Distribution of Savings at Natural Person
Federal Credit Unions
By Account Size
1970 vs 1981

	1970		1981		
Share Account Size	Percent Distribution No.	Amt	Percent Distribution No	Amt	Changes in Distribution of Amount (1970-81)
$2,000 or less	90.8	39.3	85.3	23.6	-15.7
$2,000 - 5,000	7.2	32.8	9.0	22.3	-10.5
$5,001 - 10,000	1.6	17.3	3.5	20.7	3.4
$10,001 - 20,000	.4	8.6	1.8	19.3	10.7
$20,001 or more	1/	2.0	.5	14.1	2.1
TOTAL	100.0	100.0	100.0	100.0	

This increase in larger accounts was also influenced by the generally rising level of interest rates and the creation of new share certificate programs that often required higher minimum or initial balances. The years of highest growth in the $5,000 and greater account balances also tended to coincide with the period when credit unions had a rate advantage over regular passbook and savings accounts. The credit union regular share limit of 7% was significantly higher than the Regulation Q imposed limits on banks and S&L's.

Distribution of Total Savings at
Natural Person Federal Credit Unions
By Account Size
1970-1981

Share Size Category	70	71	72	73	74	75	76	77	78	79	80	81	'82
$5,000 or less	72%	67	63	60	58	52	47	43	44	47	42	43	42
$5,001 or more	28%	33	37	40	42	48	53	57	56	54	58	57	58

Changes in Reserves and Total Equity

As share insurance became widespread there was corresponding pressure to lower the statutory reserves for credit unions. This was based on the belief that insurance created an external pool of reserves which allowed each individual credit union to lower its own reserves because of access to the common fund in the event of an emergency. This lowering has occured twice in the decade of the 1970's - once when insurance was first passed and again in 1977. In addition, because of the then 12% usury ceiling on loan rates, the NCUA waived the regular reserve for all credit unions in 1979 and authorized a limited waiver in 1980. The result has been a lowering in both statutory and statutory plus retained earnings ratios in credit unions during the period of federal share insurance. These ratios would also have deteriorated as total growth accelerated during the period since additions to reserves are created from setting aside a designated percentage of gross income. The effect of this method is that increases in reserves generally lags the growth in total assets.

Selected Reserve Ratios to Total Assets of Natural Person
Federal Credit Unions, 1970-1982

Year Ended 12/31	Ratio (%) of Total Reserves to Total Assets	Ratio (%) of Retained Earnings To Assets	Ratio (%) of Total Reserves & Retained Earnings to Total Assets
1970	6.60	1.42	8.02
1971	6.13	1.36	7.49
1972	5.79	1.36	7.15
1973	5.60	1.31	6.91
1974	5.46	1.35	6.81
1975	5.10	1.24	6.34
1976	4.84	1.17	6.01
1977	4.48	1.25	5.73
1978	3.93	1.39	5.32
1979	3.95	1.73	5.68
1980	3.90	1.90	5.80
1981	4.10	2.29	6.39
1982	3.90	6.36	2.46

In addition to the trends from federal credit unions NCUA asked Credit Union Leagues, State Supervisors and other share insurance funds to comment on the 36 year period without insurance as compared to the 12 year period when insurance was available.

In comparing the growth rate, most respondents could find no difference.

> I do not believe the lack of insurance had any significant impact on growth. As the following statistics indicate, the greatest percentage rates of growth occurred before share insurance was available. (South Carolina Credit Union League)

> Statistics for Virginia Credit Unions do not reflect that passage of federal or state share insurance had an initial impact on the growth of credit unions in this state. In 1947 there were 79 credit unions in Virginia, by 1957 the number had increased 178% to 220, by 1970 the number had increased to 370, an increase of 68% and by 1972, two years following the introduction of NCUSIF, the number had increased to only 381, or an increase of 3%. Assets increased 655% from 1960 to 1970 and only 60% by 1972. A major portion of this latter increase was due to the addition of Pentagon Federal Credit Union. (Virginia Credit Union League)

> The impact of share insurance on Illinois Credit Unions as far as growth in assets is difficult to assess due to economic factors, maturing of the industry, etc. In the 42 years prior to implementation of NCUA insurance, Illinois credit unions experienced an annual growth in assets of approximately 18.47% compared to the 9.97% annual growth rate since 1971. (Illinois Department of Financial Institutions)

> In large measure, we would contend that the economic growth that did take place since 1970 has, in fact, been a result of inflationary considerations, rather than "real growth".
>
> The statistics over the past decade do indicate, however, that credit unions have had one significant, perhaps positive, influence with share insurance, and that is the ability to attract larger savings accounts. Prior to 1970 it was very uncommon to have savings accounts with balances of $5,000 or more, while

> that is not at all uncommon today; we literally have thousands of Ohio citizens who are members of credit unions with savings or share certificate accounts in that amount or larger, with millions of dollars so invested. (Ohio Credit Union League)

> We must recognize at the onset that from the early days of credit unions, other financial institutions did not offer insured accounts to $100,000, $40,000, or even $20,000, but rather the lesser amount of $10,000. During this era, the typical credit union member was a farmer, or a bluecollar worker, and the services offered to them were the basic loan and share account. The deposits were usually small and the depositors had little concern for safety and soundness or insurance. They were typically small homogeneous groups, pooling their savings and, in turn, loaning them to each other. We can find no evidence to support the premise that the lack of share insurance affected growth. (North Carolina League)

Credit union growth in savings does not appear to have suffered because of a lack of insurance nor does insurance appear to have increased the rate once in effect. This does not mean there were not positive impacts as will be described later under "Insurance Brought Benefits."

Share Insurance and Problem Credit Unions

In the 12 years of NCUSIF existence, total income from premiums and investments has been $417.7 million and total expenditures $239.8 million. If administrative or overhead costs are subtracted, the direct costs for merger, liquidation and other losses caused by problem credit unions has been $161.2 million. In addition to approving and, when necessary supporting mergers, the Fund has also paid out 1,564 liquidations totalling $241.7 million net shares. The volume of this activity alone would seem to support the need for a Fund, however when examining the 36 year pre-insurance period, credit unions had a remarkable if not outstanding record of managing problems at minimum or no cost to shareholders. In fact, the rate of liquidation appears to have significantly increased since share insurance. The techniques with which the State Regulators, Leagues and Bureau of Credit Unions managed problems to minimize losses to members were many. NAFCU summarizes the experience of FCU's in this non insured period as follows:

> Between 1934 and 1970, nearly 6,000 Federal credit unions were liquidated, representing a total of $135.3 million in assets. This involved mostly small occupational credit unions and resulted from the closing of plants, firms or insufficient membership. Due to the cooperation of state leagues, other credit unions and the central credit unions in transferring the loans and savings accounts of members to other area credit unions, net losses to members were kept down to approximately $1.8 million for all Federal credit unions prior to 1971.

As the following credit union league comments show, losses at the state level were also minimal to non existant becaue of a variety of programs and "self-help" activities. Frequently there is also the assessment that credit unions without insurance were more conscious of safety and and soundness.

> While liquidation records reflect that some few credit unions liquidated at less than 100¢ on the dollar, the majority paid a liquidating dividend. Because of lapse of time, liquidation was never an agreeable choice. A side benefit, however, was the encouragement of shareholders to borrow to settle loans in order to speed up pay-back.
>
> The League Board of Directors, upon recognizing a trend nationally to establish stabilization programs, appointed a Study Committee and in 1962 recommended to the membership that a Stabilization Fund be established from League income and maintained as a on-going fund to assist League member credit unions to pay-back 100% in liquidations. This fund was approved by the membership and later, after NCUSIF, changed to provide for stabilization assistance to troubled credit unions to avoid liquidations. This fund is still on the records of the League and grows only by the occasional recovery of a debt in liquidation. The Fund has been used to assist the liquidation of thirty-three credit unions at a net cost of $5,553.04, or an average of $171.00 per credit union since its establishment. (Virginia Credit Union League)
>
> The absence of share insurance in the early days of credit

unions might be compared to the absence of candy from a young child's diet: i.e. - never having had it, it wasn't missed. The safety and soundness of that era was probably not as great a problem as it is today.

Yes, we had liquidations and the pay-out often took years, but the members generally paid. Why? Because they knew failure to do so was having a first-person effect on their friends and neighbors. While today with the big insurance fund of our Federal Government, members are often less sensitive to the need to pay. With share insurance, the "plain vanilla" credit union of yesteryear was required to keep its own house clean and, in doing so, might very well have done the better job of protecting member deposits than managers of our "full service" credit unions of today. (North Carolina Credit Union League)

The effect of share insurance was minimal. Very few credit unions failed because of bad loans to members. Loan ceilings were low and very few credit unions had excess to invest. The lack of "protection" also caused boards to be more conserative with loans and investments.

The Mississippi League Stabilization was used extensively to avoid losses due to failure. It was also used as a support system for state credit unions who failed to qualify for NCUA Share Insurance when it became mandatory. (Mississippi League)

The Michigan Credit Union Act was first adopted in 1925. Since then the credit union movement has experienced steady growth although this growth has moderated since the mid 1970's. In 1955 the League established its Stabilization Fund. From that point to the early 1970s there have been approximately 600 liquidations and mergers. No losses resulted. Losses for the period prior to 1955 were minimal. Consequently, member confidence in Michigan credit unions has always been high. (Michigan Credit Union League)

I do not know of many credit unions where there were financial and/or operating problems that couldn't be worked out with some effort and joint cooperation between the credit union and the regulatory agency. This was the preferred method of dealing with this type of problem, as contrasted to a capital infusion. We had a number of credit unions where member savings were "scaled-down" as a means of restoring solvency and the credit union resumed normal operations. In a number of instances, these share-write-downs were later restored when the credit union resumed its economic growth and improved its Undivided Earnings position. (Ohio Credit Union League)

> Records that we have available indicate no large losses during that period. Credit Union basic services offered during that period did not expose them to high risks. To our knowledge, only one South Carolina credit union ever suffered a share scale down and that was a small credit union of approximately $20,000 in assets. (South Carolina Credit Union League)

> In Wisconsin we have always had less than 1/2 of 1% of the total number of credit unions as federally-chartered credit unions. There never was a League level stabilization fund in Wisconsin. Back in 1955, the League sought and obtained a charter for its State Central Credit Union. This credit union was a statewide individual member credit union as well as a credit union corporate credit union. When credit unions had to liquidate, State Credit Union would purchase the assets of the liquidating credit unions at such a price that the members would always be paid off 100 cents on the dollar and as State Central Credit Union had a statewide membership there was no problem in transferring the individual member accounts to State Central if those members so desired.
>
> During the period without insurance Wisconsin had an enviable record as no credit union member in that period of time lost any money on the liquidation of that member's credit union. (Wisconsin Credit Union League)

Federal Share Insurance Impacts on Local "Self Help" Methods

The advent of Federal share insurance has tended to concentrate the management, the resources and the liquidation of problem credit unions in the Fund. In effect, functions that had been performed in a variety of ways by many organizations including Leagues, sponsoring companies, State regulators, and members were now performed at the Federal level. As noted above, many states were proud of the efforts put forth to resolve their own problems when insurance was not available.

> Credit unions were considered safe and sound and those few that did liquidate because of adequate reserves were able to pay out at or near 100 cents on the dollar.
>
> In our state we occasionally found volunteers to liquidate credit unions and collect on loans thereby reducing the expenses to the

> liquidating credit union and returning all of the proceeds to the credit. In one instance, several credit unions purchased the loans of a liquidating credit union at face value and then each credit union took a proportionate loss on these loans after all efforts to collect were exhausted.
>
> Our stabilization fund prior to share insurance assisted several small credit unions (mostly (O.E.O.) that did not make it. When share insurance became a reality, the large Federal credit unions that were members of our fund withdrew from the pool and pulled their funds from the Stabilization Fund. We were then forced to dissolve the Fund.
>
> In the period without insurance, we had to work closely with credit unions in helping them set policies, hold down dividends in order to build up undivided earnings and pay more attention to delinquent loans. (Arkansas Credit Union League)

As the NCUA or other insurers took over the workout or stabilization functions, the "can do" spirit of self help tended to be less needed.

> The safety and soundness aspect of it was largely taken care of during the period of pre-insurance by the leagues across the country organizing stabilization programs.
>
> We solved problems without insurance in those days by everybody working harder at preserving the credit unions. Prior to insurance we seldom talked about outright liquidating a credit union. We talked instead of finding the ways to preserve the credit union and expand it and make it grow. We, in short, searched harder for the given cause of the problem and tried to correct it. Perhaps that's one of the shortcomings with insurance programs because I don't see that same feeling on behalf of boards of directors to be so anxious to perserve an unhealthy credit union. Now, with the event of insurance, it seems to me they are more likely to "throw in the towel" and let the insurance fund take care of the problem. (Utah Credit Union League)

Insurance Brought Benefits

Comments on the "benefits" of 12 years of share insurance from the user's standpoint did not focus much on safety and soundness, faster growth, or other quantifiable impacts. Credit union share insurance was not born in adversity; it was born in a time of strength. Therefore share insurance is primarily seen as having had a qualitative impact on member confidence through marketing appeals and perhaps through raising the level of managerial skills and innovativeness.

> Share insurance has helped credit unions compete with other financial institutions for deposits. It has helped credit unions provide more services to their members and it has given credit unions a better image in the financial field. (Arkansas Credit Union League)

> Now when considering the 12 year period since the beginning of NCUA insurance, the major advantage has been a selling point when competing with other financial institutions. It sells the idea of safety and soundness. (North Dakota Credit Union League)

> Insurance has provided a tremendous marketing tool for credit unions.
>
> Insurance has prevented numerous disasters in liquidating credit unions by not only saving deposits but by avoiding damaging publicity that would have occurred with large scale downs. (South Carolina Credit Union League)

> One of the major advantages in having share insurance is the fact that this now requires a minimum level of competent management for all insured credit unions, as established either by the appropriate regulatory agency or by the insuring agency, or both. If a credit union does not measure up to the minimum established criteria, its corporate existence is seriously questionable. The insurance operating expense cost has not been a significant additional burden for credit unions, certainly as contrasted to the benefits that can be obtained by having share insurance. I feel that the insurance requirements have, to some extent caused management and Board of Directors to become more conservative, and to take a broader but balanced view of their corporate affairs. (Ohio Credit Union League)

> Share insurance might very well be looked upon as "a Good Housekeeping Seal". There is something about an insurance decal on the front door, or in the newsletter, or on the letterhead, which says, "my credit union has the Good Housekeeping Seal of Approval." This has been especially important during the past decade as credit unions have moved away from that all too familiar niche of "plain vanilla"to a full service, sophisticated financial institution offering a full array of services. John Q. Public has become more rate conscious more aware of the many services and opportunities available and, in so doing, has wrapped himself securely in the insurance security blanket.
> With share insurance, has come an expansion of powers, which has permitted credit unions to develop a porfolio of services which equal and, sometimes, exceed those of other financial institutins. These services have attracted members with larger deposits. This has fostered a steady growth during the last decade. With this has come a degree of "cockiness" . . . venturing out further and further with the knowledge in the back of the mind that should something unforeseen happen, the big insurance fund in Washington, D. C. will come to the rescue. (North Carolina Credit Union League)
>
> There is much less hesitancy in sponsors to permit the organization of new credit unions since insured funds are guaranteed. (Virginia Credit Union League)

Concerns with Insurance

While Share insurance has given an enhanced sense of security to credit union members and been used to compete with other insured institutions some concerns were reported. However, none of these is so severe that the fundamental existence or value of federal insurance is questioned.

> The advantages of avoiding a pay out of less than 100¢ is obvious and the rapid pay back to shareholders is highly desirable. On the otherhand, there is a complacent feeling of "why worry" when trends are poor. Liquidation is more convenient now and requires less management from a volunteers viewpoint. Operational "health"problems are never perceived as being quite as serious as they formerly were.
>
> The Virginia Credit Union Movement was developed on the concept that some members must take some risk in order to render financial aid to other members. Members were closer to their credit unions because of this risk and on occasion were willing to "scale down" their shares to keep the credit union

> operating. Since the development of insurance, there is no opportunity to measure a member's loyalty to the purpose since he risks only the earnings and not a part of his principle investment. (Virginia Credit Union League)

> The obvious disadvantage is that insurance premiums are monies that cannot be used for further capitalization in the credit union or return to its members. (North Carolina Credit Union League)

> The major disadvantage seems to me that the existence of share insurance especially on a federal level, has shifted the nature of the examination and regulatory process away from solvency and compliance with federal or state statute, to an inspection of activities that have, or could have adverse impact on the share insurance fund, and quite unrelated to the interests of the credit unions. (Ohio Credit Union League)

> The major disadvantages are additional federal regulations, and that NCUA's philosophy has changed from saving credit unions to one of saving the insurance fund. (South Carolina Credit Union League)

> Federal share insurance use has tended to contribute to regulatory conflicts between state and federal credit union regulatory agencies. (Idaho Credit Union League)

As can be expected, Federal and state share insurance programs which developed over the past 12 years did not eliminate credit union problems. Rather they shifted the responsibility from numerous self-help and often informal methods of assistance given by Leagues, other credit unions, and sponsoring organizations to NCUA and private insurers. While NCUA's liquidation resources are more centralized and concentrated than pre insurance methods, NCUA's losses from share payouts of approximately 40¢ per $1.00 are substantially greater than any reported in the earlier stabilization programs.

A frequently mentioned undesirable difference of share insurance is the belief that the sense of responsibility for problems has lessened at all levels in the movement, from the individual member who asks only about insurance coverage when seeking the highest possible rate; to the credit union management and Board which, because of share insurance, now "steps bolder and quicker" into new services; and to the State Leagues and national trade organizations who have formally dissolved most of the stabilization programs previously in existence.

> The public is aware of the insurance of deposits and may tend to become somewhat lax in feeling their deposit is safe since it is insured. Less thought is given to where to deposit funds since they are insured. (Maine Department of Business Regulation, Bureau of Banking)

> Since Federal insurance became mandatory for Michigan credit unions, there has been a change of attitude noted within some credit union's management. This is reflected by more and more credit union's dependence on share insurance to solve their problems. In some cases Section 208 Assistance, Reserve Waivers, etc., promotes poor management and induces credit union management to take extraordinary risks. (Michigan Credit Union League)

> The principal disadvantage seems to be an intangible one as may be evidenced by a lack of a positive attitude for responsibility on the part of the credit union official family. At times, there seems to be a feeling that the credit union management does not have the ultimate accountability for safety of credit union assets since any loss will be picked up and covered by the guarantor. (Florida Department of Banking)

Are Cooperative Savings Different?

These changes in attitude are most dramatically highlighted by the responses received on the issue of whether the savings of member owned cooperatives have different insurance needs than those of other financial institutions. Some believe that all savings insurance coverage is the same, regardles of institutional structure.

> The National Association of Federal Credit Unions (NAFCU) believes that the insurance needs of member-owned cooperatives such as credit unions are no different that the needs of other financial institutions. It is particularly essential that credit unions have federal insurance equal to that of other financial institutions, especially in a dynamic economic environment such as we see today. While credit unions did grow and prosper during the period without federal insurance, we firmly believe that it would be impossible for them to have become as strong an industry as they are today without the backing of a federal share insurance fund. (NAFCU)

> With deregulation, we are rapidly achieving a level playing field for all financial institutions. While the facade may be different, the back-offices are quickly melting into one. (North Carolina Credit Union League)

Many respondents, however, felt strongly that the insurance coverage for a cooperative should be different.

> As a practical matter, no member investment in a cooperative should be at risk simply because of its cooperative nature. On the other hand, a cooperative such as a credit union appeals to a member's philosophical instincts to help a fellow member, even at risk if need be. Credit unions and credit union assets were originally invested with the philosophical risk mentioned. (Virginia Credit Union League)

> I believe that the insurance needs of member-owned cooperatives do vary from other financial institutions. This relates to the very relationship between a credit union member and a depositor in a commercial bank or savings and loan association. In the latter categories you are talking about a creditor, as contrasted to a member-owner. (Ohio Credit Union League)

> I do believe that the insurance needs of credit unions differ greatly from invester-owned institutions. There is a much greater need in the credit union business for stabilization-type assistance. There is a greater stake in that we are talking about preserving the shares of all the members, as opposed to in another financial institution, preserving the stockholders' stake in the organization, so I think the insurance needs differ greatly. We must maintain our ability to provide stabilization

> assistance when in the long haul it would be in the best interest of all the members. (Utah Credit Union League)

> The credit union concept of "not-for-profit" and "member-owned cooperative" is the unique difference from other financial institutions, and because of this difference a separate regulatory agency and a separate insurance fund are essential. (New York Credit Union League)

And, in the middle ground, the "realist" viewpoint suggests that while credit unions may have been different in the pre-insurance era, the new "environment" that exists today requires that the share insurance take on the role and, if necessary the losses, previously absorbed elsewhere in the credit union system.

> I have to assess this period without insurance as being the real "cornerstone building" of the credit union movement. It was built on trust, confidence, honesty, and all of those good virtues that go along with persons banding together for a common cause. That is the reason why credit unions prospered as well as they did without insurance. It was a needed building block to move into the greater fields of service which we not have.
>
> However, that was in a totally different environment than we are now in. I feel that the growth of credit unions during that uninsured period would not have been positively affected by deposit insurance but, on the other hand, the environment we are now in really demands it. Also during that period, I would have to say that it did not affect credit union safety and soundness for the same reasons as already mentioned. The loans were very small and were a very small part of the total credit union book of business and in the event there were some losses, they did not really severely impact the credit unions and, beyond that, people were of a mood that allowed them to accept lower or sometimes no dividend when things were not going well. That is no longer true today. (North Dakota Credit Union League)

Combining the Best of Both Era's

Today the credit union system still retains some of the self help programs although NCUA's Fund is the dominant source of risk pooling and stabilization. NCUA insures 80% of all credit unions. Like the other private share insurance funds, it also is the primary source of capital for an insolvent credit union cooperative. However the tradition and practice of non governmental solutions to problems still exist in that over 500 credit unions do not have any insurance and that share insurance is not mandated in 4 states. There are 16 private insurance funds which provide a mutual financial guarantee to their members' institutions; stabilization funds still provide assistance in several states and the methods of sponsor support, dividend reductions, and other kinds of credit union and member self-help are still used when problems come up. But many of the trends point to an increasing reliance on the NCUSIF as the sole source of stabilization.

Need For Change

We believe that the challenge for the system now is to develop a form of share insurance which combines the best elements of both eras. In this way, credit unions can retain their unique cooperative character and maintain their to members' security and confidence in the credit union system. The later parts of this study suggest how these two concepts can be combined.

For NCUA, such an approach is increasingly important from a financial perspective. Unlike the other two insurance funds, the NCUSIF was formed without any initial capital. It was undoubtedly believed that the low or non existent loss rates would continue into the era of federal insurance and that the combination of premium income and interest on investments would rapidly build the Funds' equity to the desired 1% normal operating level. This did not happen and instead the ratio of fund equity to insured shares has declined in each of the past 3 years. The attached Annual Report details these trends in the Fund. The capitalization and sharing of risk by credit unions within the Fund needs to be reexamined and we have set forth specific proposals in Item 3.

Additional Price of Share Insurance

Not only does the insuring function bring increases in reports, examination and supervision, rules and changes in reserves and operations,it quite naturally encompasses other forms of government regulation. Specifically, federal insurance, or the ability to qualify for federal insurance has subjected credit unions to monetary reserves, EEO Executive Order (attempted by the Labor Department), the Credit Restraint Program of the Federal Reserve Board in 1980, the jurisdiction of the FFIEC and the Interlocks Act. These indirect burdens of insurance sometimes do cause credit unions problems:

> As mentioned earlier, the growth of credit unions has slowed since the mid 1970s. This could be attributed to the increased complexity of operations caused by the advent of automation and/or the increasingly complex laws and regulations promulgated by the legislature, Congress or the regulatory agencies. Undoubtedly, economic conditions have also played a part. Credit unions are for the most part operated by volunteers. It is possible that volunteers have lost their enthusiasm under the weight of overregulation. (Michigan Credit Union League)

SUMMARY

Unlike the origins of the FDIC and the FSLIC, credit union share insurance was a recognition by Congress of the success or the financial "coming of age" of the cooperative financial system. Credit unions had established their presence in the market without insurance. The cooperative self-help philosophy also contributed to the development of a significant number of non federal share insurance options.

In practice, NCUA insurance has operated at an increasingly higher level of activity reflecting both the economic problems of the past three years plus an increasing dependence on federal insurance for problem resolution. These trends are described in detail in the enclosed Annual Report. The result of this 12 years of insurance has been the creation of a unique system of specialized stabilization and payout support for credit union financial cooperatives. We believe that this system is essential, but when placed in the full perspective of credit union development, changes can be made that will improve the effectiveness of federal share insurance for the future benefit of all credit union members.

Because **FDIC insurance is good for banks it doesn't follow that credit unions need it. Credit unions are different from banks.**

The issue is freedom vs. bondage

In conclusion

To ask for absolute security is to give up freedom. We believe the credit union people have a right to risk their own money in order to do a better job for themselves, without being forced to insure themselves, and be subject to all the restrictions, red tape, cost and loss of freedom of action that go with it.

If you have any questions, or for more information write

CREDIT UNION NATIONAL ASSOCIATION
MADISON 1, WISCONSIN

Insur, Share 22

why SHARE INSURANCE *is* UNNECESSARY *and* UNDESIRABLE *for credit unions*

E PLURIBUS UNUM

Share insurance **is not to be confused with CUNA Mutual's Life Savings Insurance. We're talking about the government FDIC-type of insurance which some banks have, and the FSLIC insurance some savings and loan associations have. This type of insurance has been proposed for credit unions, and we believe this type of insurance is wrong for credit unions. We believe this for the reasons outlined in this folder.**

Share insurance is wrong in principle

Credit unions are private membership organizations. The savings of members [illegible] are shares in the business.

When a man buys shares in American Tel. & Tel. or U.S. Steel, he doesn't expect the government to insure his investment. It would be no more logical for the government to insure the shares of a credit union than it would be for the government to insure the shares of any other corporation.

Credit unions don't do business with the public. Only members may borrow; only members may save. FDIC insurance covers the deposits of the public; it doesn't protect the shareholders of the bank.

Credit unions don't need share insurance

1. Operations of credit unions are sound.

Only 14/100 of one percent of loans have been charged off as uncollectible.

2. Reserves are adequate.

By law, every credit union must set up reserves for bad loans; many put more in reserve than required by law, just to be more safe.

3. Assets are liquid.

Credit union loans turn over almost twice a year. By law, credit unions can make only conservative investments; they can't speculate.

4. Losses are low.

80% of all Federal credit unions that went out of business did so with no loss to members, and most paid more than 100 cents on a dollar! Most losses were small, and almost all were losses due to defalcations (dishonesty) which can be covered by bonds.

5. [illegible]

There is no need for share insurance because we already have plenty of safeguards.

STOP·LOOK·LISTEN

Credit Unions are chartered and supervised by the government.

The government examines credit unions.

A supervisory, or audit committee of members is required to make regular audits and reports to the membership.

The board of directors meets frequently and is responsible for the sound operation of the credit union.

A credit committee passes on all loans; prevents mistakes in judgment that might be made if one man held this power.

Training and education programs improve operations and safety. Hundreds of classes, institutes and workshops are held year-round throughout the country

Credit unions don't have the same risk banks have. Most bank losses are due to bad investments, crop failures, frozen assets, etc. But the credit union field is personal loans, so we don't have this risk.

Here are two new safety measures

NEW FEDERAL CREDIT UNION LAW

In spring of 1955 the Bureau of Federal Credit Unions got the power to set bonding requirements. That means the Bureau of Federal Credit Unions now requires a Federal credit union to have a "blanket bond": a certain amount of insurance, in proportion to its size, to protect against loss because of dishonesty, failure of a person to faithfully perform his duties, loss due to burglary, robbery, larceny, theft, hold-up, and messenger hold-up, forgery or alteration, misplacement and mysterious disappearance.

NEW 100% BOND COVERAGE

A new bond now insures credit unions up to 100% of their true total assets—up to one million dollars! (Yes, even if the true assets of the credit union were concealed, and bond premium was paid only on a lesser amount, in the case of a claim, the total true assets would be covered, up to a million dollars!) It's estimated by CUNA that in only two years, all credit unions using the CUNA bonding service will have the 100% bond. Well over half the Federal credit unions already have the 100% bond, and credit unions are signing up for this insurance at the rate of about 250 a month!

* **Note: If the two credit unions that had large losses were covered by this 100% bond, now available, the members would not have lost a penny! These losses occurred before the Bureau of Federal Credit Unions had power to set bond requirements.**

[illegible]

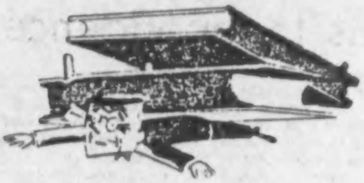
Share insurance would limit services credit unions could give their members.

It would restrict them on the type of loans they could make. This would cut down on loans they could make to members who couldn't get credit anywhere else; it would tend to make credit unions more conservative. It could tie the hands of the credit committee.

Share insurance would discourage credit unions from solving their own problems.

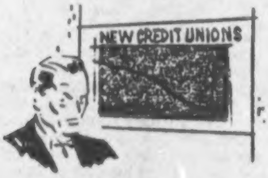
When the going got rough, they would tend to cash in on the insurance rather than solve their own problems; liquidations and losses would probably go up. But we know credit unions can solve their own problems: even the two credit unions that had the largest losses of all time are operating, are paying dividends, and their membership is growing.

Share insurance will work an undue hardship on volunteers in small credit unions, increase paperwork and costs.



The cost is out of line with the protection.

Because there's so little risk of loss, the cost is not justified. This will be just another expense to the credit union.



Share insurance would cut down the number of new credit unions.

It would be harder to get a charter for a new group. The Bureau of Federal Credit Unions admits this. Restrictions and regulations would slow us down in organizing new credit unions, and prevent us from bringing credit union service at all to many people who desperately need it.

Yet as credit union people, we realize our responsibility to organize more credit unions, to bring credit union benefits to all people, as soon as possible. Share insurance would severely hamper us in this work.

Some of our best credit unions got off to a slow start, with many strikes against them, yet today they're giving wonderful service to thousands of people. Many of them probably wouldn't have been organized if they had to qualify for share insurance before they got a charter.

TULSA, OKLAHOMA WORLD
MARCH 5, 1983

Credit Union Independent; Folks Like it That Way

"... We like living right and being free."
— Merle Haggard

By MIKE FLANAGAN
Of the World Staff

Those words from "Okie From Muskogee" could well be the motto of a fiercely independent little credit union in Muskogee.

Although financial institutions of all sizes and kinds have been shaken by the recession, the Muskogee District Telco Credit Union remains determined to bear total responsbility for its soundness.

It is one of only five Oklahoma-chartered credit unions and savings and loan associations that have declined the federal insurance that has made American financial institutions the most stable in the world.

All five are small institutions, and Oklahoma banking officials have long assumed that they objected to the cost of the insurance offered by the National Credit Union Administration and the Federal Savings and Loan Insurance Corp.

That's true in some cases, but Telco says money is the least of its concerns.

What bothers Telco, manager James Downs said, is the prospect of federal meddling.

"My board is made up of older men who feel that if you let the federal government get a toehold, they will dictate," Downs said. "They are hard line. They do not desire the kind of meddling you get in schools and federal grants."

The Oklahoma Banking Commission identifies Telco in its latest annual report as an "uninsured institution," but Downs said that the designation means only that Telco is not insured by the National Credit Union Administation.

Downs said his board has put its money where its mouth is by insuring the credit union with a private insurance carrier. "We pay $1,500, $1,600 a month in premiums," he said.

Downs said the insurance fully protects Telco's 1,025 members, who, as the credit union's name suggests, work for the telephone company in the Muskogee area.

With $2 million in assets, Telco is "one of the most stable credit unions in Oklahoma," Downs said. He said one reason the credit union stays fit is the trimness of its staff. "There are three people on the staff, including me," he said.

Downs said all state-chartered credit unions may one day be forced by the banking commission to buy the federal deposit insurance, but that "as long as we don't have to, we don't want to."

There are 56 state-chartered credit unions in Oklahoma, and only three others are not federally insured. They are OG&E Employees Credit Union in Oklahoma City, the Muskogee Iron Workers Credit Union and O.T. (Oklahoma Transporation) Employees Savings & Credit Union, also based in Oklahoma

See Credit Union on A-4

Credit Union Proud of Its Independence

Continued from A-1

City.

Unlike Telco, the OG&E credit union has found the cost of NCUA insurance premiums excessive, but it may nevertheless glue NCUA's insurance decal on its door.

"I think the board is reconsidering," said manager Margaret Andrews.

Ms. Andrews said the OG&E credit union found that it could more economically protect its depositors by maintaining a reserve account. Another factor was the nature of the credit union's membership, she said.

"The credit union is for OG&E employees only. The membership is very stable, so loans made to them did not require insurance," she said.

"Of course, times change, so we are looking into depositors' insurance," she said.

The OG&E credit union has about the same assets as Telco, $2 million, but it has 3,100 members.

Only one of 26 state-chartered savings and loan associations, the Atoka Building and Loan Association, is not covered by federal insurance.

Nor does the small Atoka organization carry private insurance, operating officer John Fain said.

Fain said he believes insurance is unnecessary because the association deals only in first mortgages.

Only state-chartered credit unions and savings and loan associations are allowed to pass up federal insurance. It is required of all federally chartered institutions.

All of the 313 state-chartered banks in Oklahoma are protected by the Federal Deposit Insurance Corp., which insures accounts up to $100,000.

Summary of State Chartered Credit Union Share Insurance/ Guaranty Corporations

Name and Address	Year Incorporated	Membership Deposit (Capitalization)	Premium (Annual)	Maximum Coverage	Number of Credit Unions Insured	Amount of Savings Insured	State(s) of Operation
California Credit Union Share Guaranty Corporation Post Office Box 2322 Pomona, California 91769	1961	1/2 of 1% of share capital	1/12 of 1% of shares	$150,000	9	$ 441,005,500	California
Connecticut Credit Union Share Insurance Corporation 1268 Main Street Suite 104 Newington, Connecticut 06111	1973	1% of shares	1/12 of 1% of shares	$100,000	0	—	Connecticut
Florida Credit Union Guaranty Corporation 8000 South Orange Avenue Suite 108 Orlando, Florida 32809	1975	1/2 of 1% of net guaranteed	1/20 of 1% of funds guaranteed	$100,000	207	$ 592,000,000	Florida
Georgia Credit Union Deposit Insurance Corporation 2990 Brandywine Road Suite 220 Atlanta, Georgia 30341	1974	1% of first million of shares deposits and dividends payable, plus 1/2 of 1% of next $4 million, plus 1/4 of 1% of amounts over $5 million	1/12 of 1% of shares, deposits, and dividends payable	$100,000	130	$ 450,000,000	Georgia
Maryland Credit Union Insurance Corporation 8501 LaSalle Road Baltimore, Maryland 21204	1975	1% of shares and deposits	None	$100,000	28	$ 376,938,000	Maryland
Massachusetts Credit Union Share Insurance Corporation 950 Mechanics Bank Tower Worcester, Massachusetts 01608	1961	1% of shares and deposits	1/12 of 1% of shares deposits	Full account limit	237	$1,913,046,264	Massachusetts
National Deposit Guaranty Corporation 555 Metro Place, North Suite 185 Dublin, Ohio 43017	1974	1% of shares	1/12 of 1% of shares	No limit	404	$1,300,000,000	Ohio, West Virginia, Illinois, Nevada, California, Minnesota, Arizona, Indiana, Idaho, Missouri
Nebraska Depository Institution Guaranty Corporation 1644 Woodmen Tower Omaha, Nebraska 68102	1978	1% of shares, savings, and deposits	1/10 of 1% of shares, savings, deposits, and certificates of indebtedness	$ 30,000	2	$ 450,000	Nebraska
New Mexico Credit Union Share Insurance Corporation Post Office Box 239 Los Alamos, New Mexico 87544	1973	1% of share and deposit balances	1/12 of 1% of total share and deposit balance	$100,000	0	—	New Mexico
North Carolina Savings Guaranty Corporation Post Office Drawer 2688 Raleigh, North Carolina	1967	1.25% of insured savings	1/12 of 1% of insured saviangs	$100,000	24	$ 723,201,000	North Carolina

Name and Address	Year Incorporated	Membership Deposit (Capitalization)	Premium (Annual)	Maximum Coverage	Number of Credit Unions Insured	Amount of Savings Insured	State(s) of Operation
Rhode Island Share and Deposit Indemnity Corporation 1060 Park Avenue Cranston, Rhode Island 02910	1965	1% of total insurable deposits	1/12 of 1% of insurable deposits	$100,000	57	$ 551,690,147	Rhode Island
Secured Savings Credit Union of Kansas 8410 West Highway 54 Wichita, Kansas 67209	1975	1% of insured savings	1/10 to 1/20 of 1% of savings depending on the solvency of the credit union	$100,000	0	0	Kansas
State Credit Union Share Insurance Corporation Post Office Box 21130 Chattanooga, Tennessee 37421	1974	1% of savings capital	1/12 of 1% of savings capital	$100,000	454	$ 930,000,000	Kansas, Missouri, Tennessee
Texas Share Guaranty Credit Union Post Office Box 14584 Austin, Texas 78761	1975	1% of insured savings	1/10 of 1% of insured savings	$100,000	396	$1,402,300,000	Texas
Utah Share and Deposit Guaranty Corporation Post Office Box 26008 Salt Lake City, Utah 84115	1973	1/2 of 1% of total assets	1/20 of 1% of shares and deposits	Full account except $100,000 for corporate	171	$ 325,000,000	Utah
Virginia Credit Union Share Insurance Corporation Post Office Box 11469 Lynchburg, Virginia 24506	1974	1% of shares	1/12 of 1% of shares	$100,000	120	$ 178,612,000	Virginia
Washington Credit Union Share Guaranty Association Post Office Box WCVL Bellevue, Washington 98008	1975	$25 plus contingency reserve fund 1/2 of 1% of shares and deposits	1/18 of 1% of shares	$100,000	159	$ 785,118,731	Washington
Wisconsin Credit Union Savings Insurance Corporation 5011 Monona Drive Madison, Wisconsin 53716	1970	1/2 of 1% of savings capital	1/12 of 1% of savings capital	$100,000	585	$2,200,000,000	Wisconsin
Program for Shares and Deposits Insurance Fund Office of Inspector of Cooperatives of Puerto Rico Apartado 4108 GPO San Juan, Puerto Rico 00936	1981	1% of total savings and deposits	Set by Board of Directors	$ 40,000	173	$ 388,960,419 (as of 6/30/82)	Puerto Rico
TOTALS					**2,155**	**$12,141,417,061**	

NOTE:
Information on number of credit unions insured and amount of savings insured is as of December 31, 1982, unless otherwise indicated. The Connecticut and New Mexico corporations discontinued operations during 1982.

SOURCE:
International Share and Deposit Guaranty Association
2990 Brandywine Road, Suite 220, Atlanta, Georgia 30341

2

Item 2

The feasibility of providing depositors the option to purchase additional deposit insurance covering deposits in excess of the general limit provided by the law and the capabilities of the private insurance system either directly or through reinsurance to provide risk coverage in excess of the general statutory limit.

NCUA Share insurance coverage per member account was initially set at $20,000 in October 1970, raised to $40,000 in October 1974 and to $100,000 in March 1980. These changes appear not to have been motivated by a concern that the old limits had become outdated or superseded by increasingly larger consumer savings balances. Rather changes in federal insurance coverage have been used as a marketing tool for federally insured institutions to offset the longstanding dilemma of resolving Regulation Q limits on rates paid to savers. Whenever rising interest rates caused disintermediation from these insured institutions and attempts at deregulation failed, Congress seemed to resort to the alternative of greater insurance coverage. The last increase in 1980 to $100,000 proved insufficient to stop the funds flowing to money market funds from federal financial institutions. Congress finally mandated deregulation via the DIDC, but did not modify the insurance increases passed earlier.

The $100,000 coverage today far exceeds the average credit union account balance of $1,367. Only .0015 of natural person members have accounts above $40,000 although these balances equal 7% of total savings. It may be possible therefore, as discussed at the end of this section, to reduce federal insurance coverage and still maintain more than adequate protection for the consumer; but such a change would have to be made in concert with FDIC and FSLIC. For there exists among credit unions a strong belief that this "competitive equity" in the offering of federal share insurance should be maintained.

> Although many credit unions do not have deposits above the insurance limits, we believe that it is improper for credit unions to purchase less than the required $100,000 worth of insurance. There should be some consistency for all credit unions so as not to confuse the public. A lower amount of federal insurance would affect the competitiveness with other federally-insured institutions since the comparative analysis and benefits could be emphasized publicly which would be detrimental. (Hawaii Credit Union League).

> The option to have less than the current market place limits would have a negative reaction and would infer that the credit union or any other financial institution was an inferior facility. (Washington Credit Union Share Insurance Association)

Private Share Insurance Sometimes Exceed Federal Limits

Some private share insurance corporations have developed coverage in excess of $100,000 and some federally insured credit unions have purchased this additional coverage. Massachusetts Credit Union Share Insurance Corporation offers insurance above the $100,000 limit to its members and to federally insured credit unions in the Commonwealth. The Puerto Rico law requires all shares to be insured; NCUA insures the first $100,000 and by agreement, the Program for Shares and Deposit Insurance Fund Puerto Rico insures all amounts in excess. In Florida, a member credit union may apply to the Guaranty Corporation for additional coverage and, if approved, the limit can be raised. The National Deposit Guaranty Corporation from Ohio insures the total of all shares and deposits of its member credit unions and has reached agreement with at least one federally insured credit union to insure amounts over the $100,000 limit.

One other state insurance corporation wrote:

> "We believe that the ability to provide depositors with additional insurance is a good concept. Our SGC offers higher coverage and more flexible coverage that the NCUA. With the advent of larger savings accounts such as IRAs and Keoghs many

> credit unions will be reaching a level of deposits from individual members that will exceed $100,000. Conversely, there may be smaller credit unions or certain fields of membership that would not have large deposit bases and would like the flexibility of covering their accounts only to a certain maximum. We believe that some flexibility in this area could be attractive if it is developed correctly. (California State Guarantee Corporation)

The NCUA has no objection to federally insured credit unions contracting with private insurers for coverage in excess of NCUA's limit. We believe this business decision should be made by each credit unions' Board of Directors.

Additional Insurance Purchased by Individual Saver Not Practical

The question of whether depositors individually should have other options of purchasing coverage in excess of the current federal limit does not seem practical for credit union members. Insurance coverage while for individual accounts, is granted to an institution. Savings insurance is not based on an individual's risk but rather the risk of the institution in which funds are placed. If an individual is seeking coverages in excess of the $100,000 federal limit available at a single institution then the person would have to find a credit union or other financial institution which had contracted with a private insurer for such excess coverage. As indicated above a number of private insurance corporations do offer such programs.

Further Issues

There are several additional issues raised in this item. Should NCUA offer varying amounts of insurance? Should, for example, credit unions have an option of a lesser or greater amount of coverage than the current $100,000? Should there be differences in the amount of coverage offered to the individual saver by NCUA, FDIC, and FSLIC? If coverage were to vary by credit union how should this be done? Should the cost of insurance remain the same regardless of the level of coverage in place?

From the vast majority of credit union and state supervisory respondents to this study, Federal share insurance in a deregulated market place is believed to be essential for credit union's competitive parity with other federally insured institutions.

> The effect of a "variable" insurance coverage would most likely be construed by depositors as a diminution of the importance of coverage. This could lead to lessening of credibility for credit unions involved, in particular, and the industry in general. (New York State Credit Union League)

Federally insured financial organizations have not hesitated to point out (directly and indirectly) the uninsured status of their money market competitors thereby suggesting that insured funds are a better investment. However this perception that federal insurance is essential to successfully compete is not supported by the 36 years of non-insurance nor by the fact that non federally insured institutions appear to have the same financial success as do federally insured credit unions. Moreover the remarkable success of the money market funds would suggest that "insurance security" is not an essential requirement for a large number of consumers. This reluctance to contemplate strategies without federal insurance suggests that once this "security blanket" is in place, it is extremely difficult to modify, let alone reduce or eliminate. Moreover because of the apparent advantage of insured accounts versus uninsured funds, there is a desire on the part of some credit union people to be able to increase the current $100,000 federal insurance coverage or ideally to have all shares, whatever the amount, federally insured to be able to use this fact to the fullest in the competition for funds.

Coverage and the Purpose of Federal Insurance

Questions about the extent of coverage raise the issue of the purpose and impact of federal insurance for credit unions. As noted in Section 1, credit unions strongly resisted the idea of federal share insurance which was passed only after a long period of opposition. When enacted, the coverage was patterned after the operations of the FDIC & FSLIC even though there were and still are unique factors in the operations of credit unions. One of these factors, the cooperative financial structure, was changed by share insurance because insurance essentially means that shares are no longer at risk. Share insurance dramatically reduced, if not eliminated, the sharing of potential losses by members. This consequence removed the options of scale down of shares and other forms of member and sponsor stabilization assistance and has contributed to an increase in the rate of liquidations and mergers of credit unions throughout the period of federal insurance. The impact of insurance in eliminating the risk to the credit union shareholders is to cause the Fund to become the insurer of each credit union's safety and soundness. As noted in earlier comments this reality has, in the judgement of many credit union observers, caused managers, Boards, and members to become less rigorous in resolving problems due to the assumption that the Fund will always insure that no member loses any covered savings. Two state regulators described this change as follows:

> In Vermont, deposit insurance for credit unions was not required until 1979. Credit union management has taken a more relaxed approach in a number of cases as far as collection of delinquent loans are concerned, fully realizing the depositors money is protected. (Vermont Department of Banking and Insurance)

> Insurance has affected safety and soundness in my opinion in a negative sense in that it appears that many credit unions have disregarded safety and soundness to some degree because they knew that the shares of their members were protected by an agency of the federal government. We have experienced, especially in the last four years, a greater degree of credit union failures, mismanagement, unsound investments and other negative happenings, some of which could be attributed to the false sense of security that comes with the provision for insurance of deposits. (Texas Credit Union Department)

NCUA believes that the purpose of federal share insurance is limited. Federal insurance offers the individual member the assurance that savings and transaction funds necessary for the routine needs of a market economy should not be at risk. An individual in today's economy should be able to deposit a reasonable amount of funds in any institution and always have them available without being required to constantly monitor the safety and soundness of the institution and worry about loss. Insurance should not be used to protect the aggressive rate shopping investment opportunist seeking a superior market return nor should it be used to support or guarantee the institutions which choose to undertake abnormal risk and suffer uninsured losses.

As of December 31, 1982 NCUA insurance covered over 99% of all savings in federal credit unions as can be seen by the following distribution:

Distribution of Number and Amount of Savings
of Natural Person Federal Credit Unions By Account Size
12/31/82

Savings Size Category	No. Accounts	Amount	Percent Distribution No. Accounts	Percent Distribution Amount
$2,000 or less	25,442,642	$8,585,289,724	84.2	20.8
$2,001 to 5,000	2,826,303	8,644,220,994	9.4	20.9
$5,001 to 10,000	1,125,268	8,136,558,879	3.7	19.7
$10,001 to 20,000	610,748	8,308,853,249	2.0	20.1
$20,001 to 40,000	174,739	4,735,844,205	.6	11.5
$40,001 to 99,999	44,424	2,508,270,602	.1	6.1
$100,000 or more	2,778	394,785,869	1/	1.0
TOTAL SAVINGS	30,226,928	$41,313,823,522	100.0	100.0

1/ Less than one-half of one percent.

We believe that the extension of deposit coverage to the point that the Fund becomes the sole source of risk capital leaves the NCUA in the practical role of being the financial guarantor of credit unions. This function is neither the role of NCUA nor the desire of most credit unions. Therefore changes are necessary to bring back a balance, or a cooperative sharing of risk, into federal share insurance coverage for credit unions.

Change In Insurance Coverage: Recommendations for Statutory Action

To reestablish a balance of risk sharing for credit union cooperatives, we recommend changes in NCUA's statutory insurance coverage. First we believe that all credit union members should share in their organization's risk to a minimum extent. NCUA coverage should be changed to eliminate insurance of at least the initial share subscribed by members. These amounts, the par value of which is set by each federal credit union Board of Directors, would be available to cover losses in the normal operations and, in the event of liquidations, would be paid back to members only after all other creditors including the Fund had been paid. This change would have the effect of creating a "deductible" aspect to credit union share insurance coverage. This proposal is similar in concept of the "membership share" recommended in the Capitalization Commission Report (See End of this Section)

Secondly although credit union respondents believe they need to retain coverage comparable to FDIC and FSLIC for consumer deposits, there needs to be some flexibility in NCUA's pricing of this common coverage. The vast majority of credit union members have less than $50,000. In a deregulated environment some credit unions have aggressively sought to attract large savings balances by offering special rates and other terms for the large saver/investor. Often these funds are attracted solely through price (rate offered) and the credit union is forced to seek higher than normal rates of return on investments or loans to match these fund sources. To respond to this kind of situation we believe the Federal Credit Union Act should be changed to permit the Board to establish a tiered pricing system when assessing insurance premiums. As an example, share balances $50,000 and under - @ 1/12 of 1% and share balances $50,000 - $100,000 - 1/6 of 1%. If a credit union did not wish to be subject to higher premiums for larger shares it could elect to limit member accounts to a lower priced tier. This approach would not create any change in coverage between federal funds. Therefore the consumer does not have to sort among different federal insurance programs.

Retaining uniform coverage among insured institutions was a concern expressed by several respondents so that competition for funds did not become a battleground among insurance coverages.

> We have considered, on several occasions, the expansion of our present coverage of $100,000 to an unlimited amount but find that, (1) few deposits in Virginia would be covered by the expanded amount and, (2) a standard form of coverage (as provided by FDIC, FSLIC and NCUSIF) is less confusing to members of our insured credit unions. We are firmly convinced that the battleground of competition between financial institutions should not include deposit insurance. The credibility of all who choose to participate and some who had not so chosen would be the price. (Virginia Credit Union Share Insurance Corporation)

Under the above procedure, pricing of coverage could be adjusted by the Board to reflect increased exposure associated with larger account balances.

Thirdly we believe that all federally insured credit unions should have the option of purchasing private insurance above the federal maximum. Current law allows this and private insurers are seeking to develop this excess coverage. This option is important as there will be unique or developing situations such as the growth of IRAs and Keogh acounts, corporate credit union accounts, etc. that would seem to be potential markets for extended insurance coverage. Rather than increase federal coverage above the current limit, or to single out special situations, the use of private sector insurance should be encouraged for institutions which wish to use non federal insurance to attract these funds.

Finally if the other insurance funds find it advisable to limit coverage to a lower amount than the current $100,000, NCUA would have no objection. The current $100,000 limit is so high that few consumer balances are near the limit. Moreover an entrepreneurial "brokerage" and "exchange" industry has developed to distribute large investor balances in $100,000 lots among insured institutions which effectively substitutes insurance for market discipline. Lowering insured limits to $40,000 or $50,000 would not adversely impact the average consumer and would increase the transaction costs for both buyer and seller of CD's so that once again it becomes practical, if not more economically efficient, to search out and pay for investment advice rather than mindlessly distribute funds among dozens or hundreds of insured institutions.

May 1982 (pages 23-25)

Membership Shares

One of the major factors hindering the ability of credit unions to build capital has been their failure to fully tap external capital sources. As noted earlier, other financial institutions faced with similar problems have increasingly resorted to new stock issues. The Commission adopted the concept of the Membership Share as the cooperative way to generate external capital. (See Table II on page 24 for a brief description of major features of Membership Shares.)

Features of Membership Shares. As perceived by the Commission, Membership Shares would represent a member's ownership interest in the credit union. All members would be required to buy one share with a limit of one share per member, thus perpetuating the cooperative principle of democratic control.

Like present credit union shares, Membership Shares would be subordinate to the claims of non-owners. However, they would have greater permanence or continuity than present shares. Membership Shares would not be pledgeable as collateral (although the credit union would have the right of offset), would not be transferable other than to the issuing credit union, and could be redeemed or withdrawn only upon termination of membership. Also, they would be at risk, uninsured, and their value could be written down if the credit union had operating losses.

With these characteristics, Membership Shares could reflect equity of a more permanent nature. This equity would be in addition to the undivided earnings and reserves held by credit unions and would provide an additional cushion for operations. The equity would be available to absorb investment, loan or operating losses; to provide expansion capability; to provide leverage for borrowing to maintain liquidity; and to project stability to members, potential members, regulators and others. As a result of instituting Membership Shares, a credit union's members would enjoy the benefits of a higher capital level—higher dividend rates on savings, lower loan rates and more attractive service prices.

Board to set par value. Membership Shares would also have a par value greater than the current $5 minimum (par value would be set at the discretion of the board of directors). Capital growth estimates were developed, using December 31, 1979 data from 234 credit unions, for various increments in par balances (See Table III page 26). While percentage increases in equity would vary by credit union, this projection indicates increases in credit union capital ranging from 9% for a $10 minimum Membership Share to 182% for a $200 minimum Membership Share.

Membership Shares are proposed by the Commission as an additional source of credit union capital, not for speculative purposes. Their par value would not be guaranteed by the credit union and shares could be written down in value in the case of operating losses.

Table II

Membership Share Features

1. **Membership Shares would be eligible for dividends at the discretion of a credit union's board of directors and could be added to Membership Share balances, thereby increasing equity until the dividends are withdrawn.**
2. **With positive operating results, dividends could be substantial. However, dividends would not be mandatory.**
3. **Membership Shares would be limited to one per member and would be nontransferable except to the issuing credit union, continuing the cooperative principle of democratic control.**
4. **Par value would be set at the discretion of the board of directors.**
5. **Par value would not be guaranteed and values could be written down.**
6. **Membership Shares would be at risk and uninsured; share insurance premiums would not be paid on these balances.**
7. **Right of redemption and withdrawal would be limited to termination of membership.**
8. **Membership Shares could not be pledged as collateral. This would prevent circumvention of the redemption rule. However, credit unions would have the right of offset.**

Item 3

The feasibility of basing deposit insurance premiums on either the risk posed by the insured institution or the category or the size of the depository institution rather than the present flat rate system.

The principal supervisory responsibility of NCUA is the identification of credit union activities and trends that present a danger to members' savings and ultimately to the share insurance Fund. The purpose of supervision is risk assessment, control, and minimization of loss if severe problems do occur. However we believe as discussed below that the linkage of the monitoring and control of risk to insurance premiums paid to the NCUSIF is incompatible with the role of federal insurance coverage and impractical in implementation.

Arguments for Risk Rating

The arguments for the risk rating of insurance coverage are based on the common sense principle of fairness or equity — premiums should be proportionate to the probability of loss — and on the common practice of most private insurance programs of relating risk and premiums through actuarial methods (risk underwriting). Also the concept is based on the market principle that higher pricing will influence managers and Boards whose institutions are evaluated as being more risky to change their activities to more prudent courses of action. The changes would be likely because of the cost incurred through the higher premium and because of the fear of loss of public or member confidence if ones "federal insurance rating" were to become known.

Some of the reasons for administering NCUA insurance on this basis were supported by the respondents to this study.

> I personally favor risk rating by Federal insurers assuming that an equitable method of risk can be determined, easily monitored and uniformly applied. Risk rating will, in large part, add incentive to eliminate operational or management deficiencies, thereby reducing the risk and premiums. The primary problem of such a program will be the consensus needed for implementation. (Illinois Department of Financial Institutions)

> There would be an incentive for credit unions to improve their condition. It would be helpful for credit unions to recognize and deal with their problems in the early stages rather than letting problems go hoping they would solve themselves. (North Dakota, Department of Banking and Financial Institutions)

> There are several good reasons for basing deposit insurance coverage on risk. I cannot answer for the federally chartered credit unions, but for the state chartered credit unions a premium based on size deposit makes sense. I believe the risk rating is the best method. The credit unions that are generally clean and well managed would benefit from this approach and would not have to pay the freight for the less well managed shops. It would tend to indicate to those shops that changes are in order and improvement must be made. (Maine Department of Business Regulation)

Some Credit Unions Favor The Concept

In a survey of NAFCU's membership in February 1983 in which 238 Federal Credit Unions responded, the concept of basing credit union insurance premiums on risk was generally felt to be advisable:

> Do you feel that it would be advisable to alter the federal insurance system to permit NCUA to base credit union insurance premiums on risk to the insurance fund? YES: 55.6%. NO: 26.4%. NO OPINION: 18.0%

The Massachusets Credit Union Share Insurance Corporation stated "I think it is an idea whose time is finally come and should be worked out and put into place."

Problems with Risk Rating

However the problems with risk rating were many and well argued by other state regulators and state insurers. Instead of changing behavior and lessening risk to the Fund, a higher premium may bring about just the opposite result.

> The public may find out how their credit union is rated and it could create a run. (North Dakota Department of Banking and Financial Institutions)

The concept of increasing premiums to an institution in difficulty is often impractical.

> It would be nice to risk rate credit unions, but impractical. The very credit unions that cannot afford the higher rates would have to pay them. (State of Wisconsin, Office of the Commissioner of Credit Unions)

> The credit union having the highest degree of risk would likely be one that could least afford a higher cost of coverage. A higher rate for higher risk might well accentuate problems for troubled credit unions. One consequence is more liquidations with higher losses. (Florida Credit Union Share Guaranty)

The problem of assessing and fairly assigning risk to an appropriate premium scale was also raised.

> We are of the opinion that basing deposit insurance premiums on risk would necessitate development of a rating system that, to even approach fairness, would be highly complex and a source of perpetual controversy. (New Mexico Financial Institution Division)

> Risk rating by federal insurors has the benefit of requiring those that represent the greatest risk to supply the most capital to the fund. However, because of the leveraging multiples of the insurance fund to the insured risk, I question whether or not the pricing differentials will actually be proportional to the risk differentials. I doubt that any of the insurance funds can raise the price of share insurance realistically in proportion to increases in risk or threats to the fund.
>
> While some form of price or dividend adjustments may be possible protection of the fund will be better served by accurate analysis and corrective procedures. It is not a function of price. (State Credit Union Share Insurance Corporation - Tennessee)

- Also external factors such as changing economic, market and competitive environments could alter an institution's relative riskiness independent of any change in that institution's internal financial trends or condition. This is uniquely applicable to credit unions with their close sponsor relationships and dependence.

> It is felt it might be difficult to determine the risk of a particular institution. Particularly during the last eighteen months with such a volatile economy, when sponsoring companies are experiencing unexpected layoffs and shutdowns. Certainly, one could not determine such risks by 12 to 18 months examinations. (Kentucky Department of Banking and Securities)

> Risk rating does not appear to be feasible. The relative degree of risk is difficult, if not impossible, to establish in advance. Size alone is not a proper criteria. A widely-held belief — for many years — was that the large credit union, adequately staffed with professional management had the smaller risk. The events of the past years have clearly disproved the validity of this concept since liquidations and losses have

> occurred in credit unions of varying sizes. Actual losses for the larger credit unions have been as great as those for smaller credit unions.
>
> The intangible evaluation of management. the board of directors, and other members of the official family is required. Any such assessment is subjective, and does not appear to be capable of quantification with any degree of reliability. Significant problems would be presented if risk rating took into account the essential element of competency of management. Even regulators might be very reluctant to reclassify a credit union into a higher risk category as a result of a poor management evaluation. Personalities would be interjected into the system and this appears to be objectionable.
>
> Objective criteria are mere indicators and are not universally determinative of the extent of risk. (Florida Credit Union Guaranty Corporation)

One state share insurance corporation concluded that risk rating would result in no net improvement for the insurer.

> Risk rating is probably the most idealistic means of administering the funding of a deposit insurance program but has several basic flaws, (1) the evaluation and risk rating process cannot be equitably administered, (2) the border line insured financial institution can least afford to pay an additional premium for its deposit insurance, and (3) the concept is regressive in that some financial institutions would opt to pay an increased premium rather than address and rectify its problems. In effect risk rating is condoning sub-standard operations for a prescribed fee. (Virginia Credit Union Share Insurance Corporation)

In their review of this issue, the Credit Union National Association did not support the concept and referred to the Hunt Commission's conclusions.

> We note that historically the FDIC, the FSLIC and NCUSIF premiums have never been based on risk.
>
> In 1971, the President's Commission on Financial Structure and Regulation (Hunt Commission) rejected a variable insurance rate proposal that would have established different rates depending "on the character of the risk relative to the capital of the

> insured bank." The problem with the proposal, according to the Commission, was a practical one. The Commission did not see "how differences in risk can be evaluated with sufficient precision to be adequately reflected in insurance assessment." Further, the Commission was also concerned that innovative institutions would be penalized if new or different activities carried on by the insured institution were regarded as high risk activities. Also, if the public became aware that one institution was paying higher rates it might assume that institution was in difficulty, remove deposits and increase the likelihood of even more severe problems. These reasons continue to be compelling. (Credit Union National Association)

An academic study in 1980 for the Credit Union Reserve Board entitled "Variable Rate Deposit Insurance Premiums for Credit Unions in British Columbia, "concluded:

> This study shows that it is extremely difficult to put risk of failure on anything like an actuarial basis. Despite the substantial efforts in recent years to zero-in on these variables providing early warning about failures, a rational premium system based on research that has been completed so far would be difficult to defend.... The present system with fixed rates for deposit insurance is to date the best operational system. (pages 21-22, "Variable Rate Deposit Insurance Premium for Credit Unions in British Columbia," Credit Union Reserve Board, August 1980)

Why Government Insurance and Risk Rating are Inconsistent

But even if risk rating were theoretically possible and practical, several commentators pointed out the inconsistency of this activity being undertaken by the federal government.

> Risk rating has and will continue to be a standard, and successful insurance practice in the private sector. One reason for its success is that a consumer or organization has a choice of insurers. I do not feel that risk rating deposit insurance by a single government would be beneficial to the credit union industry. To change rating practice at a given point in time would only compound problems of the weaker credit unions and this could create immediate heavy losses to the Insurance Fund. (Michigan Department of Commerce)

> On the surface, at least, having insurance premiums based on risk will create havoc. Those who can least afford the cost will have to absorb it, eventhough their particular problems may be of short duration. I assume the risk level would be a variation of predetermined points resulting in several premium levels. This, in itself, would be disconcerting, but even more so would be having a bureaucratic entity setting one standard for all credit unions regardless of individual problems best left to be resolved on an individual basis. Such a system would result in additional reporting requirements, etc., for federally insured state-chartered credit unions. In conclusion, being Big Brother is not always best. (Vermont Department of Business and Insurance)

> Risk rating for deposit insurance guaranty by a federal or state agency would be difficult to admnister because there is no alternative if you were dissatisfied with the rating. (Washington CU Guaranty System)

These comments raise the fundamental issue of whether a government share insurance program should risk rate. We do not believe that government pricing should be used as a form of risk rating but that rather any variations in premium should be used primarily to raise sufficient income to support the expenses of the fund.

Government share insurance is not a form of actuarially based risk coverage similar to the concept of private insurance. Rather as shown in Part 1 on the origins of deposit insurance for the FDIC and FSLIC, government insurance was a response to events and circumstances of such a disastrous or extensive nature that no rational estimates or reasonable planning could have forseen or managed. Those events in the depression years undermined the functioning of the market economy. Public confidence could only be restored by a political process which superseded purely market judgements. The country had to collectively unite to overcome a national economic tragedy.

Government insurance or guarantee is often the necessary political response when the private market place can no longer manage a problem whose solution is deemed to be critical to the well being of society as a whole. To restore the financial system in 1934, government gave the public depositor an assurance that there was no probability one's funds would be lost in the event of an institution's failure. This zero probability of loss could not have been underwritten by any organization other than government in the economic conditions which then existed.

What began as "last-resort" insurance to a very nearly fatal economic problem has evolved into a situation where insurance is now the primary distinguishing feature of any new federally chartered financial institution. We believe this change from a "last resort" role. to a legal requirement of market entry for every institution leads to the practical problem of government becoming de facto, the guarantor of an institution or industry in the sense of ultimately bearing the risk for all failures. For government insuring agencies to risk rate will only perpetuate and increase this function, not reduce government exposure. In fact such action when government has a monopoly on insurance issuance, will only involve government more inextricably in the business decisions and strategies of financial institutions.

Alternatives to Federal Insurance — A Choice for All Credit Unions

To limit governments' insuring exposure but still retain its proper "last resort" public policy function, we recommend individual Federal credit unions be given the authority to elect alternatives to Federal insurance. All credit unions should be given a choice of private or governmental share insurance.

Private share insurance is available as described in Part 1. Each of the 16 programs has differences in premiums, capitalization, coverge, and oversight methods that in effect, amount to variations in pricing equivalent to risk rating. These private programs are encouraged by NCUA. We believe their track record and operations are the best argument for the alternative of private insurance and the variety of pricing and risk management that the private sector can bring to this area of risk pooling. These private corporations have every incentive to provide programs for their members that are responsive to changing conditions and needs. If they do not respond they will cease to exist. Credit unions insured by the private sector show no distinguishable financial (e.g. growth in shares) or other statistical indicators of member acceptance that are different from federally insured credit unions. The private funds also report better financial results than does the NCUSIF as measured by the loss ratios incurred for payouts of insured shares. Morover, we expect that once an option exists, the incentive to develop creative and competitive private plans will be increased.

> Our review of credit union growth in Virginia does not indicate any significant difference between federal chartered (NCUSIF insured) and state chartered (VACUSIC insured) credit unions. We find that a more significant impacting factor has been the economic viability of the industrial organizations which sponsored the credit unions and provided employment for its members. (Virginia Credit Union Share Insurance Corporation)

Change Necessary in Capital Structure of NCUSIF

Once credit unions have a choice, we believe NCUA insurance will continue to play an effective role as a government insurer of last resort. However the Fund must be based on premuim income at a level necessary to manage the problems of its members. In order to do this, however, we believe that changes are necessary in the way the NCUSIF is capitalized. NCUA Insurance is a cooperatively funded stabilization and liquidation insurance organization administered by an agency of the federal government. To be successful in carrying out its role as "insurer of last resort," the Fund does not require a government guarantee. Government involvement in the form of an emergency liquidity backup facility through the U.S. Treasury is sufficient.

Both the FDIC and FSLIC were intitally capitalized in part with government funds. The FDIC, when founded, received $150 million from the U. S. Treasury and $139 million from the Federal Reserve Banks. The FSLIC received $100 million from the U. S.

Treasury. The NCUSIF, when it began, asked for and received $0.

While this assessment of initial capital needs may have been accurate in light of the very low level of losses suffered by credit unions in the preinsurance era, subsequent events described in Part 1 show that this initial approach was too optimistic for the Fund's attaining the statutory 1% "normal operating level" in the near future.

We recommend that, in consultation with the industry, credit unions be given the chance to capitalize their fund with a one time assessment of insured shares of 1%. This amount would be sent to the Fund and would, if necesary be available with other reserves to absorb losses. The annual premium would remain, but perhaps be modified to introduce tiered pricing as discussed in Part 2. The 1% deposit by each insured credit union would be maintained for the duration of the credit unions participation in the Fund. Giving federal credit unions the choice of share insurance would strengthen the Fund through competition, expand the underwriting opportunities for private insurers, and thereby give all credit unions greater control over their system's future development.

With an NCUA insurance system in place and capitalized as recommended, NCUA does not believe risk rating would be either necessary or feasible. In addition to all the reasons described earlier we believe two are compelling. Risk rating, however simple or sophisticated the system, merely injects government further into the business decisions of insured institutions. Secondly the government institution implementing the system and the individuals and organization within it are never really "at risk" in the sense of being financially accountable or liable if their rating turns out to be ill founded or inappropriate as would be the case in the private sector. The practical result of government risk rating is to extend the opinions of government agencies into the dynamics of private business strategies.

Finally, if government elects to risk rate or to attempt some other means of sharing the risk of loss with the private sector, it will only be the uneducated and naive that get penalized not the sophisticated and clever. For as is already illustrated by the example of Penn Square, the private system learns its lesson quickly and well. And the lesson has not been to stop deposits to riskier institutions who pay above market rates in a deregulated environment. Rather it is to separate deposits into $100,000 lots through trust accounts and pooled funds and to encourage brokers to place funds in a larger number of institutions. Just as institutions and individuals become ingeneous in circumventing the regulatory intent of the Reg Q interest rate limits on depositors, likewise the private system will modify its behavior and practice to circumvent any attempts to share government's insurance exposure.

The only way to limit government insurance risk and loss is to limit government insurance. We believe that private sector insurance should be encouraged and that government insurance be available primarily as a "last resort" and not as a chartering requirement. If private sector insurance became so effective and attractive that all credit unions chose these options, then government could become strictly a reinsurance vehicle for the private sector organizations. While risk rating is incompatible with government insurance, it is a necessity for private insurers.

NCUA believes that the legislative changes suggested above will give credit unions a share insurance fund consistent with the cooperative financial structure of credit unions. The change in funding will provide credit unions a source of stabilization and recapitalization when necessary. These changes will permit the continued evoltion of credit unions as a unique cooperative financial system with government supervising its safety and soundness and providing prompt member payout whenever liquidation becomes necessary.

Item 4

The impact of expanding coverage of insured deposits upon operations of the insurance funds, including the possibility of increased or undue risk to the funds.

In the 12 years of NCUSIF operations, share insurance coverage has been raised twice from the initial $20,000 limit to the $100,000 amount today. While the direct connection, if any, between the increase of insurance coverage and a gain in share accounts is difficult to document, circumstantial evidence does suggest that higher insurance limits tends to increase larger account balances.

For example when comparing 12/74 account distributions for federal credit unions in the $20,000 insurance environment with the 12/75 distribution and $40,000 limit, there appears a significant shift to larger accounts.

Distribution of Savings at Natural Person
Federal Credit Unions, by Account Size
December 1974 vs December 1975

	Column 1	Column 2	Column 1 - Column 2
Savings Account Size	12/74	12/75	Difference (%)
$2,000 or less	27.7%	24.6%	-3.1%
$2,001-5,000	30.2%	27.7%	-2.5%
$5,001-10,000	20.9%	21.0%	+.1%
$10,001-20,000	15.9%	17.3%	+1.4%.
$20,001 or more	5.3%	9.4%	+4.1%
TOTAL	100.0%	100.0%	

Again when the insurance limit was raised in March 1980, there appears to be another shift to larger accounts.

Distribution of Savings at Natural Person
Federal Credit Unions, by Account Size
December 1979 vs December 1980

	Column 1	Column 2	Column 1 - Column 2
Savings Account Size	12/79	12/80	Difference (%)
$2,000 or less	21.9%	22.2%	-.3%
$2,001-5,000	23.5	22.3%	-1.2%
$5,001-10,000	21.6	21.6%	--
$10,001-20,000	20.0%	21.0%	1.0%
$20,001-$40,000	10.1%	9.4%	-.7%
$40,001-or more	2.8%	3.6%	.7%
TOTAL	100.0%	100.0%	

While other factors were also influencing the increase in average acount balances (inflation, new deposit instruments with large $ minimum balances, and high short-term rates making short-term financial assets attractive investments) the increase in insurance coverage probably accelerated the search for larger depositors.

Increased Coverage Has Limited Impact

Two state regulators described the possible impact of share insurance increases in their areas as follows:

> It probably affected credit union members in our state very little when it increased from $40,000 to $100,000. Most of our credit unions are small, with only a few members saving to the maximum insured amount. (Kentucky Department of Banking and Securities)

> Our credit unions probably benefited more from the $20,000 to $40,000 increase than from $40,000 to $100,000. (New Mexico Commerce and Industry Department)

The single most important benefit cited by respondents was that increased coverage allowed credit unions to maintain parity with the FDIC and FSLIC insurance programs.

Increased Coverage and Risk

The issue of whether increased coverage also increased the risk to the insurance fund is also difficult to document directly. However since 1980 when coverage was expanded to $100,000 there has been a dramatic increase in merger, liquidations, and other loss expenses in the Insurance Fund.

National Credit Union Share Insurance Fund
Merger, Liquidations, and Other Loss Provisions
(FY 1979-1982 — 000's Omitted)

1979	1980	1981	1982
$6,374	$32,531	$43,865	$81,084

While many factors especially the economy and the dramatic rise in short-term rates affected the safety and soundness of credit unions and hence liquidation losses, there was a significant increase in large credit union problem cases in this same period. These larger credit union problems were in a number of instances associated with rapid growth through high balance share accounts or using borrowed funds.

One state insurer expressed his opinion of the risk associated with the increases in coverage as follows:

> My assessment is that the exposure to the NCUA Share Insurance Fund was greatly expanded while the premium level for this expanded coverage was not commensurate with the risks involved. In credit unions I doubt if 5% of the members have $20,000 or more in various types of savings and deposit accounts, and therefore, I am not certain that the higher limit was really needed. We have it now however, I do not think it can be reduced. Also, I do not think it should be increased. (Texas Credit Union Department)

Credit Unions Average Share Account Is $1,367

Credit union accounts are almost exclusively from individuals. Credit unions are prohibited by their field of membership from seeking "wholesale" share accounts from the public or via brokers as some other financial institutions have done. There is no need for an increase in the coverage available for these individual depositors as the vast majority of funds are still significantly under there insured limit. At 12/82 less than 1.0% of funds were in accounts over $100,000 in natural person federal credit unions and the average account balance was $1,367. Moreover this dependence on smaller retail acounts has not put credit unions at a disadvantage when comparing overall credit union growth rates with other financial institutions. In 1982 federal credit union shares grew at a rate of 17.2%; while S&L deposits increased at 7.9% and bank deposits at 9.3%.

Higher coverage would offer few benefits to the majority of credit union members. Moreover for the reasons listed in questions 2 & 3 we do not believe higher insurance, if it were desired, should be provided by the federal government. There appears to be strong intuitive as well as practical reasons to believe that higher federal insurance would bring a disproportionate increase of risk to the Fund. The confidence engendered by government insurance is greater than just the fact that a member may easily get his money back in liquidations. As expressed by one private share insurer:

> Increases in covered deposits (from $20,000 to $40,000 to $100,000) when done simultaneously in all financial institutions provide no preferential advantage to any form of financial institution but does in effect constitute an endorsement by the insuring entity of the financial institution and its ability to weather adverse circumstances. The larger the insured amount, the more confidence expressed. (Virginia Credit Union Share Insurance Corporation)

This implicit assumption of government support for the financial insititution, not just a members account, encourages some managers and Boards to increase in risk taking activity. Several specific reasons why increased coverage adds to the overall risk of the NCUSIF were described by a State Regulator and a Share Insurance Fund as follows:

> Higher coverage on accounts will increase the risk to the NCUSIF. Larger shareholders show an increasing tendency toward rate sensitivity which should only increase with the current and future deregulation of interest rates for other financial institutions.
>
> To the extent that credit unions neglect matching assets and liabilities, and still pursue the rate sensitive share accounts the result will serve to increase risk substantially. (Illinois Department of Financial Institutions)

Increasing the current coverage limits on individual insurance accounts by NCUA represents two possible forms of increased risk to the fund. The quantity of risk, of course, is determined by the additional dollars insured. However, there are serious quality impact considerations for increased coverage by NCUA or any insurer. If increased coverage encourages significant concentrations of deposits, the individual institution and the NCUA fund may become vulnerable to the impact of short notice withdrawals and the volatility of such accounts. Examinations will have to shift dramatically to rate and liquidity risk and the match of maturity terms and cash flow with the requirements of the liabilitics of the credit union.

An additional consideration may be introduced if the increased coverage levels exceed those of general individual savings in the marketplace and represent insurance of investment risk accounts. Insurance could then represent a form of protection for entrepreneural risk funds, a major shift in function. (The flow of funds by risk takers to expanding more rewarding areas of the economy is a vital element in the success of the free enterprise system.) Insurance protection for such investment or risk funds may introduce a degree of unjustifiable speculation and yield chasing-capital shifts which are not supported by creditworthiness and long term income generation. An investor could be tempted to invest on yield with the back-up of insurance, rather than making rational decisions based on economic justification, including risk reflection. A significant increase in coverage limits beyond those required for consumer savings and transaction accounts represents a change in the form of risk assumed and protection offered by the deposit insurer. Individual financial institutions should be in the position of attracting risk and investor funds based on their efficiency of operation and creditworthiness, without substantial reliance on insurance coverage. Managers should be held responsible for the quality of their earning assets, with their performance track record and capital base serving as the enducement for risk investments, not the insurance coverage as a substitute for managerial strength. The insurer is and should remain the ultimate back-up for the public good and protection of consumer savings and transaction accounts. The economics of risk investment and entrepreneurial reward could be displaced if limits were extended to risk investments, beyond reasonable personal savings limits. (Tennessee Credit Union Share Insurance Corporation)

We concur with the above analysis. We believe the present level of federal insurance for credit unions is more than adequate to serve the needs of credit union members. Private insurers do provide coverage right now above the $100,000 limit. The private market is best equipped to assess the increased risk, if any as well as the reasons a credit union would want expanded insurance coverage, and the price needed to satisfactorily pay for this activity and exposure.

Previous insurance coverage increases from $20,000 — $100,000 were primarily to give federally insured institutions a marketing tool when Regulation Q limits caused disintermediation. Now that interest rate controls have been deregulated, there should be no increased need for insurance to serve as a marketing tool. Federal insurance thus continues its basic and limited function and does not become the guarantor of an entire industry.

Item 5

The feasibility of revising the deposit insurance system to provide even greater protection for smaller depositors while fostering a greater degree of discipline with respect to large depositors.

Credit union shareholders are almost exclusively individual savers with the exception of public unit or nonmember accounts for specified low income credit unions. Corporate credit unions receive their funds from natural person credit unions and provide investment, correspondent, and financial services through a network of some 44 "wholesale" credit unions. Most of the accounts in the corporate system would exceed $100,000 and in the case of large credit union shareholders, account balances would be in the millions of dollars.

No Increase of Coverage Needed

In the case of natural person credit unions the existing insurance limit more than covers the average current balance of $1,367. Accounts of $100,000 or larger at 12/31/82 were only 2,778 totalling $395 million or 1.0% of total shares. If the change in Part 2 were adopted to authorize a minimum of one uninsured share, we believe no other changes in coverage are needed since credit unions do not have "large depositors" similar to the corporate and commerical deposits of banks and some savings and loans. Credit unions which seek to attract funds in excess of $100,000 per account or have members requesting such coverage should be encouraged to use coverage available from the private sector insurors.

The appropriate insurance coverage for corporate credit unions is more complex. Currently some corporates including U. S. Central have no insurance coverage. Others such as Wisconsin Central Corporate Credit Union (through the Wisconsin Credit Union

Savings Insurance Corporation) have 100% of all accounts insured. Similarily, West Virginia's Corporate has 100% account coverage from National Deposit Guaranty Corporation. Thirty corporate credit unions have NCUA insurance of $100,000 per account.

There is a difference of opinion in the Corporate credit union community about the benefits of NCUA insurance. Some managers believe that the $100,000 limit is so small when compared to the average account balance that there is no practical coverage for their members. Other managers believe that insurance is necessary, not for liquidation payouts, but rather as a source of recapitalization and stabilization in the case of a severe problem or sudden, unexpected operating loss. This assistance, called 208 after the section of the Federal Credit union Act which authorizes such support, is able to be used by an insured credit union to avoid liquidation or merger.

We believe that the existing structure of insurance is at present adequate for the corporate system. However, it would be desirable to give an option to the NCUA Board to issue separate insuring rules for the corporate credit unions should this become necessary. We support the continued ability of all federally insured corporates to purchase coverage in excess of the NCUA limit from private insurors.

While changes in coverage are not needed to distinguish "large" and "small" depositors in the credit union system, if a change in coverage were to occur for banks or S&Ls, credit unions would be affected because federal credit unions alone have over $6.7 billion in those institutions as of December 31, 1982. The corporate system has at least this amount indirectly invested in these other financial institutions. To create a system where these credit union investments are put at greater risk than currently in the event of a merger or purchase and assumption would probably result in a greater use of and dependence on the investment guidance of the Corporate Credit Union Network. In addition there would be some "flight to safety" which would result in greater concentration of investment in large money center institutions and probably some shift into government and agency securities.

In the event a change in coverage is made by FDIC or FSLIC we believe the credit union system has the knowledge and ability to manage their investments in the light of any increase in risk such a change might bring.

Item 6

The adequacy of existing public disclosure regarding the condition and business practices of insured depository institutions and providing an assessment of changes which may be needed to assure adequate public disclosure.

Monthly Disclosure Since 1936

Since 1936 federal credit unions have been required to post a monthly financial statement in a conspicious location in the office(s) of the credit union. This statement includes at a minimim a balance sheet , a year-to-date income and expense statement, and a summary of delinquent loan amounts. Credit unions frequently add much more detail such as comparative data from comparable prior year periods and, extended footnotes on investments, loans or other areas of important activity. In 1959 this requirement for disclosure was incorporated in the standard federal credit union bylaws and continues to this day. A sample of this disclosure form is included at the end of this section.

This disclosure by credit unions which far exceeds that of all other insured institutions reflects their unique financial and organizational structure. Credit unions are member-owned cooperatives whose Board and committee members are elected from among the membership at an annual meeting. As cooperatives, credit union members are the owners of the institution, not just users of services; and as owners the credit union, members determine directly the information they need and want in order to bear the risks and rewards of ownership. Local disclosure at the credit union level is not just a traditional practice, but a necessity, required by the financial structure of a cooperative.

Members Serve On Boards and Committees

In addition to this financial disclosure for all member owners, the Board and committees are entirely composed of credit union members whose obligation is directly to the entire membership. There is no distinction as exists in other financial institutions between shareholders and depositors, or between large depositors and small. Credit unions do not serve the general public but a defined field of membership all of whom have equal standing in voting for their representatives. This disclosure practice in federal credit unions is also the norm at the state level.

> Illinois credit unions must post a copy of their lastest monthly financial statement in the credit union office. Several have constructed large wall signs and post changes each month to encourage growth and shareholder awareness of progress. (Illinois Department of Financial Institution)

> Michigan State chartered credit unions are required to prepare a Financial Statement within 10 days following the close of each month, and display this statement in a conspicuous place in the home office of the credit union. This disclosure adequately meets the fair disclosure requirement of a credit union's condition. All credit union policies should be available for member review, if requested. This area has not been a problem with Michigan credit unions. (Michigan Department of Financial Institutions)

This unique legal, operational and financial relationship, even dependence, which credit unions have on their field of membership creates formal and informal communications which go beyond the strict letter of the disclosure required in the bylaws.

> Credit unions traditionally have provided more than adequate public disclosure. Credit unions post financial statements in their offices, and many credit unions provide statistics and trends to their members as on-going information. Also, credit unions, as a member-owned financial cooperatives

> have been more than fair in providing information to their memberships because of the representation of that membership on the board of directors and various committees. Many of the credit unions we have surveyed disclose the footnotes to financial statements even though they are not required to do so. Probably few members ever ask for information on investments, lending policies and board meetings, but credit unions are usually more than willing to share that information. (California Credit Union League)

> Disclosure is an area that is beginning to be recognized by Boards of Directors as an important consideration in the development of effective member relations.
>
> We have seen a number of credit unions implement newsletters to their credit union members, explaining a wide variety of subjects, including policy changes that have been implemented. Moreover, in order to justify changing contractual rates on loans, as did take place two or three years ago, special mailings are being made in a number of areas. We would also note that credit unions are utilizing mail or other printed media to advertise new services, such as certificates or variable dividend rates, as well as the marketing of sharedraft programs and VISA card offerings. (Ohio Credit Union League)

NCUA also makes available to the public upon request the semi annual financial and statistical reports filed by all federally insured credit unions. Since this is essentially the same information that is routinely posted on a monthly basis in the credit union and since credit unions do not have "outside" depositors, the primary demand for this information has come from trade associations and researchers who monitor and analyze macro economic trends in the industry.

Purpose of Increased Disclosure

Potential changes in the current disclosure practices of credit unions need to be examined in the context of credit union organization and operations. In theory changes to disclosure could cover the content of disclosure (what is declared and how), the frequency of disclosure (daily, monthly, semiannually), and the level of disclosure (at the credit union level, trade association, regulator, etc.). The logic for increasing disclosure is that individuals need information to make rational economic decisions about their financial relationships with their credit union. Unless there is adequate information routinely available at the institutional level, depositors, creditors or shareholders will rely on no information (and hence make irrational decisions) or on the insurance coverage to replace rational economic choices. If the managements of institutions are not faced with the prospect of market or shareholder discipline for poor performance or decisions that result in losses, then only the regulator/insurer becomes the principal constraint on improper or inadequate management actions.

This general principle of disclosure does not apply to credit unions since all "depositors" are owners and have the monthly information previously described routinely available. Creditors, unless secured, at federal credit unions are not insured and share equally with the insurance fund in any losses in the event of a liquidaton. How individual members use the information made available may be influenced by their knowledge of insurance coverage. As described in Part 1 some observers believe members, Boards and managers are less risk sensitive when savings are insured. But member reliance on insurance instead of a close scrutiny of credit union's posted financial statement will not be changed by forcing credit unions to make more disclosures if the current information is not already being used. Rather part of the solution is to change coverage to provide a deductible as discussed in Part 2 to encourage member interest through risk sharing.

Disclosure Is Most Effective At the Local Level

NCUA believes that the responsibility for disclosure should be at the local credit union level, not from the regulators. Information should continue to be posted on a monthly basis. The content of disclosure will continue to evolve based on general economic circumstances, the scope of credit union operations, and specific credit union financial conditions.

For the regulator to try to develop increased disclosure requirements that would serve all credit unions in all situations, presupposes a knowledge of individual problems and of future economic events that no organization can have.

Voluntary Disclosure Could Be Expanded

We do believe however that there can be improved voluntary efforts by credit unions to inform members of their rights to additional data that is routinely available when a member/owner requires more information. This voluntary approach was suggested by several repondents.

> The disclosures credit unions have historically made on their financial statements are necessary, especially in a member-owned institution like a credit union, but I don't think it necessarily makes good sense to require credit unions to publicly post their investment policies or their lending policies, (members know the lending policies when they apply for a loan) or a lot of other information. I do think a member/owner of the credit union, if a member is interested in the investment policies or interested in attending a board meeting, they should have the right to request that he see the investment policies, or be in attendance at a board meeting if he so desires. But the number of people who would be interested in that would be so few in number that I don't think it makes sense to put a bunch of administrative procedures in place. I would guess only about 1 or 2% of the people would be interested, but if they are, the information should be available. (Utah Credit Union League)

And according to some Leagues this practice is already routinely followed.

> Disclosure to credit union members and its owners are presently observed under NCUA rulings and all investment policies, business practices, board meetings, and lending policies are readily made available upon request of members. (Hawaii Credit Union League)

The voluntary nature of this effort is important to balance members' need for more information in specific circumstances with the administrative burden of formal rules on managers. More data does not necessarily lend to better informed members, in fact it

> Consumers are unimpressed by detailed financial disclosures. Typically, they lack the sophistication or motivation to analyze financial statements. Moreover, the amount of disclosure necessary to truly reflect the financial condition at a given institution would be awesome. (Michigan Credit Union League)

Members Must Hold Directors Accountable for Disclosure

Ultimately in a cooperatively owned institution the members themselves, as owners, must decide and act upon the responsiveness of management to their needs and requests for information. If there is a record of inadequate or inaccurate disclosure, then ultimately members must act or as one share insurance corporation stated:

> If there is any wrongful withholding of information, the solution to the problem would be the election of new members of the board at the annual meeting. (Florida Credit Union Guarantee Corporation)

NCUA's responsibility, as a regulator, is to insure that required disclosure practices are being followed and that the information therein is accurate. This oversight is done through the examination program as part of the compliance review. NCUA's role in reviewing the quality of data requires an ongoing dialogue with credit unions because circumstances do change. One state share insurer has recommended more accurate financial disclosure as the first priority, not more data about more operational areas.

> While the letter of disclosure requirements has generally been followed, the spirit and quality of such disclosures vary widely. I suggest that the public, current members and potential members of a credit union would be far better served if the individual institutions were required to make disclosure through financial statements on the accrual basis with at least annual independent audited statements available. This would certainly improve disclosure for the benefit of members and creditors, improve management tools (in many instances) and aid the

> insuror. A significant improvement in disclosure would be the provision of a basic ratio and trend analysis report plus a change in equity statement. This would provide a better informational basis for decisions and would serve as management's report card to the membership. (State Credit Union Share Insurance Corporation — Tennessee)

The question still remains whether NCUA should release its supervisory data and examination judgements about a credit union's condition, not for the general public, but to give members some "independent" analysis of their institutions. Since the general public cannot become a member of any credit unions, there are no rating or financial evaluations available on credit unions as there are for most other financial institutions.

The disclosure of supervisory information about an institution must be balanced by the need to retain member confidence and support when problems do occur. This point was stated by a state regulator as follows:

> Public disclosure by the supervisory agency of problem credit unions would not be in the best interest of either the credit union member, the credit union or the supervisory agency. It would only serve to hasten the failure of a problem credit union and adversely affect public confidence in all depository institutions. (Michigan Department of Financial Institutions)

Change Will Continue At Supervisory Level

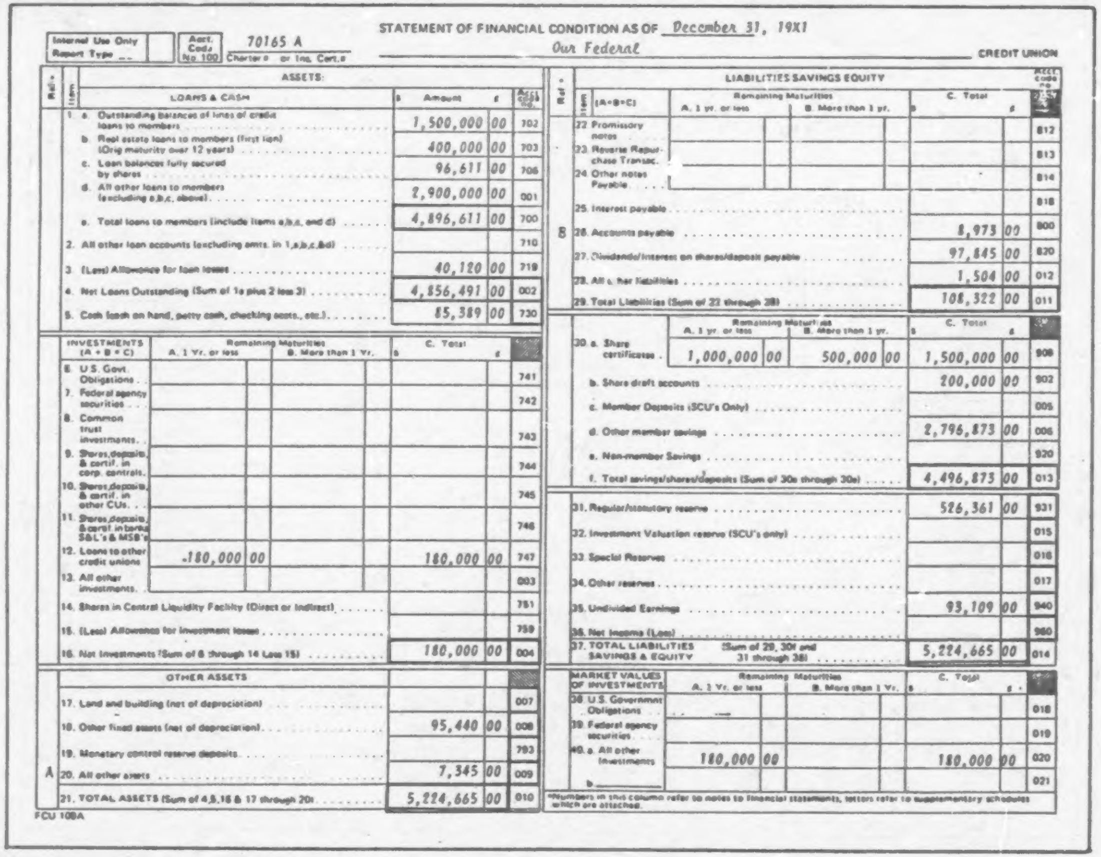
Disclosure is an evolving art not a static discipline or science. In order to improve NCUA's analysis and review of semi-annual financial and statistical reports, the Agency has developed a Financial Performance Report which was mailed to all Federal credit unions last month. This report not only prints out the data sent to NCUA in a five year balance sheet and ratio format, but also provides peer group analysis and a listing of each credit union's ratios for key peformance areas using percentile averages. If this approach proves useful and constructive, NCUA will then evaluate the release of the initial Report to interested parties such as Leagues, Corporate Credit Unions and individual members. Before going this step, however, we believe that the information should first be evaluated by managers and Boards, the Report modified if necessary, and then questions of its further distribution be discussed. A sample of this Report is attached at the end of this section.

The need for disclosure in a time of change was stated by the Ohio Credit Union League as follows:

> Overall, I feel that disclosure is a necessary condition to the improvement in member credit union relations - particularly during a period of transition in the financial sevices industry and so that members can be kept abreast of the conditions within their credit union. (Ohio Credit Union League)

NCUA will continue to supervise required disclosures and encourage any additional useful disclosure by credit unions. NCUA cannot however replace the owners in exercising their responsibilty to oversee the management of their funds.

Figure 3-1: Statement of Financial Condition (FCU 109A)



Internal Use Only
Report Type __

Acct. Code No. 100 — 70165 A — Charter # or Ins. Cert.#

STATEMENT OF FINANCIAL CONDITION AS OF December 31, 19X1

Our Federal CREDIT UNION

ASSETS:

Ref.*	Item	LOANS & CASH	Amount $	¢	Acct. code no.
	1. a.	Outstanding balances of lines of credit loans to members	1,500,000	00	702
	b.	Real estate loans to members (first lien) (Orig maturity over 12 years)	400,000	00	703
	c.	Loan balances fully secured by shares	96,611	00	706
	d.	All other loans to members (excluding a,b,c, above)	2,900,000	00	001
	e.	Total loans to members (include items a,b,c, and d)	4,896,611	00	700
	2.	All other loan accounts (excluding amts. in 1,a,b,c,&d)			710
	3.	(Less) Allowance for loan losses	40,120	00	719
	4.	Net Loans Outstanding (Sum of 1e plus 2 less 3)	4,856,491	00	002
	5.	Cash (cash on hand, petty cash, checking accts., etc.)	85,389	00	730

INVESTMENTS (A + B = C)	Remaining Maturities A. 1 Yr. or less $	¢	B. More than 1 Yr. $	¢	C. Total $	¢	Acct. code no.
6. U.S. Govt. Obligations							741
7. Federal agency securities							742
8. Common trust investments							743
9. Shares, deposits, & certif. in corp. centrals							744
10. Shares, deposits, & certif. in other CUs							745
11. Shares, deposits, & certif. in banks, S&L's & MSB's							746
12. Loans to other credit unions	180,000	00			180,000	00	747
13. All other investments							003
14. Shares in Central Liquidity Facility (Direct or Indirect)							751
15. (Less) Allowance for investment losses							759
16. Net Investments (Sum of 6 through 14 Less 15)					180,000	00	004

Ref.*	OTHER ASSETS	$	¢	Acct. code no.
	17. Land and building (net of depreciation)			007
	18. Other fixed assets (net of depreciation)	95,440	00	008
	19. Monetary control reserve deposits			793
A	20. All other assets	7,345	00	009
	21. TOTAL ASSETS (Sum of 4,5,16 & 17 through 20)	5,224,665	00	010

FCU 109A

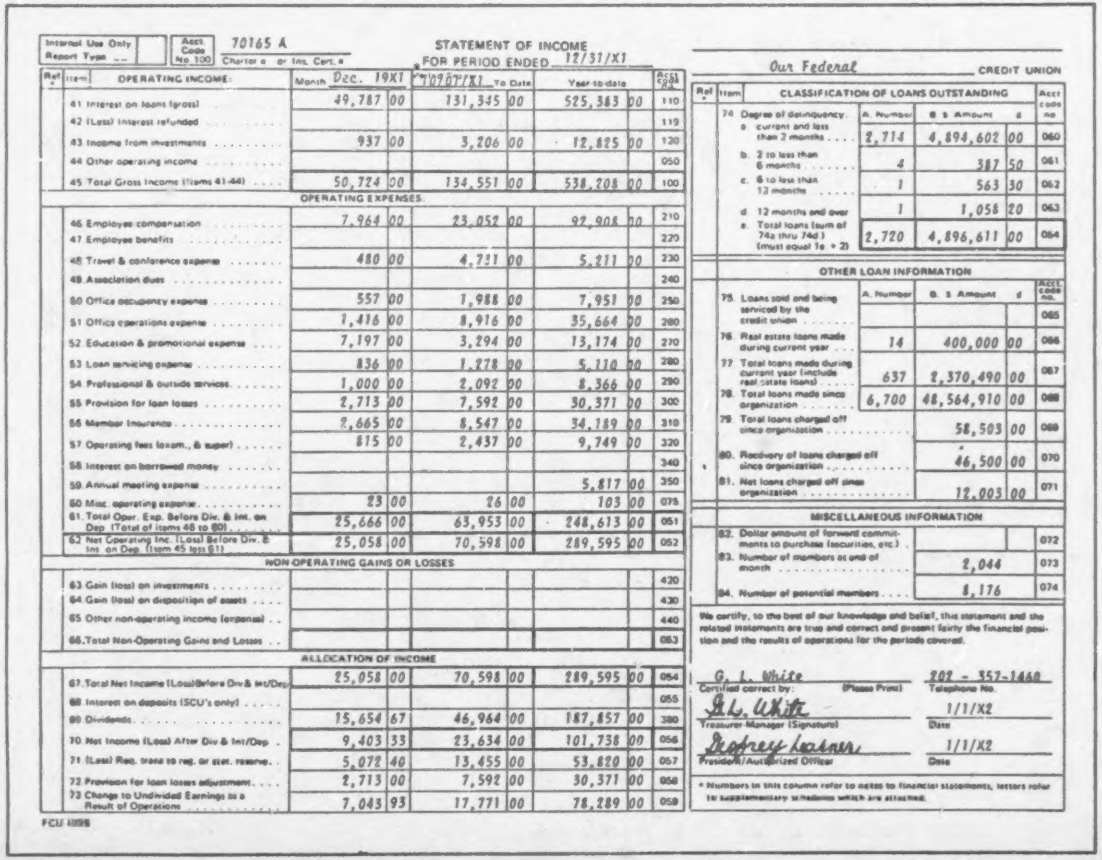
LIABILITIES SAVINGS EQUITY

Ref.*	Item (A+B=C)	Remaining Maturities A. 1 yr. or less $	¢	B. More than 1 yr. $	¢	C. Total $	¢	Acct. code no.
	22. Promissory notes							812
	23. Reverse Repurchase Transac.							813
	24. Other notes Payable							814
	25. Interest payable							818
B	26. Accounts payable					8,973	00	800
	27. Dividends/interest on shares/deposit payable					97,845	00	820
	28. All other liabilities					1,504	00	012
	29. Total Liabilities (Sum of 22 through 28)					108,322	00	011
	30. a. Share certificates	1,000,000	00	500,000	00	1,500,000	00	908
	b. Share draft accounts					200,000	00	902
	c. Member Deposits (SCU's Only)							005
	d. Other member savings					2,796,873	00	006
	e. Non-member Savings							920
	f. Total savings/shares/deposits (Sum of 30a through 30e)					4,496,873	00	013
	31. Regular/statutory reserve					526,361	00	931
	32. Investment Valuation reserve (SCU's only)							015
	33. Special Reserves							016
	34. Other reserves							017
	35. Undivided Earnings					93,109	00	940
	36. Net Income (Loss)							980
	37. TOTAL LIABILITIES SAVINGS & EQUITY (Sum of 29, 30f and 31 through 36)					5,224,665	00	014

MARKET VALUES OF INVESTMENTS	Remaining Maturities A. 1 Yr. or less $	¢	B. More than 1 Yr. $	¢	C. Total $	¢	Acct. code no.
38. U.S. Government Obligations							018
39. Federal agency securities							019
40. a. All other investments	180,000	00			180,000	00	020
b. ______							021

*Numbers in this column refer to notes to financial statements, letters refer to supplementary schedules which are attached.

Figure 3-2: Statement of Income (FCU 109B)



Internal Use Only
Report Type __

Acct. Code No. 100

70165 A
Charter # or Ins. Cert. #

STATEMENT OF INCOME
FOR PERIOD ENDED 12/31/X1

Ref *	Item OPERATING INCOME:	Month Dec. 19X1		Period 10/01/X1 To Date		Year-to-date		Acct code no.
	41 Interest on loans (gross)	49,787	00	131,345	00	525,383	00	110
	42 (Less) Interest refunded							119
	43 Income from investments	937	00	3,206	00	12,825	00	120
	44 Other operating income							050
	45 Total Gross Income (Items 41-44)	50,724	00	134,551	00	538,208	00	100
	OPERATING EXPENSES:							
	46 Employee compensation	7,964	00	23,052	00	92,908	00	210
	47 Employee benefits							220
	48 Travel & conference expense	480	00	4,731	00	5,211	00	230
	49 Association dues							240
	50 Office occupancy expense	557	00	1,988	00	7,951	00	250
	51 Office operations expense	1,416	00	8,916	00	35,664	00	260
	52 Education & promotional expense	7,197	00	3,294	00	13,174	00	270
	53 Loan servicing expense	836	00	1,278	00	5,110	00	280
	54 Professional & outside services	1,000	00	2,092	00	8,366	00	290
	55 Provision for loan losses	2,713	00	7,592	00	30,371	00	300
	56 Member Insurance	2,665	00	8,547	00	34,189	00	310
	57 Operating fees (exam., & super)	815	00	2,437	00	9,749	00	320
	58 Interest on borrowed money							340
	59 Annual meeting expense					5,817	00	350
	60 Misc. operating expense	23	00	26	00	103	00	078
	61 Total Oper. Exp. Before Div. & Int. on Dep. (Total of items 46 to 60)	25,666	00	63,953	00	248,613	00	051
	62 Net Operating Inc. (Loss) Before Div. & Int. on Dep. (Item 45 less 61)	25,058	00	70,598	00	289,595	00	052
	NON-OPERATING GAINS OR LOSSES							
	63 Gain (loss) on investments							420
	64 Gain (loss) on disposition of assets							430
	65 Other non-operating income (expense)							440
	66 Total Non-Operating Gains and Losses							053
	ALLOCATION OF INCOME							
	67 Total Net Income (Loss) Before Div & Int/Dep	25,058	00	70,598	00	289,595	00	054
	68 Interest on deposits (SCU's only)							055
	69 Dividends	15,654	67	46,964	00	187,857	00	380
	70 Net Income (Loss) After Div & Int/Dep	9,403	33	23,634	00	101,738	00	056
	71 (Less) Req. trans to reg. or stat. reserve	5,072	40	13,455	00	53,820	00	057
	72 Provision for loan losses adjustment	2,713	00	7,592	00	30,371	00	058
	73 Change to Undivided Earnings as a Result of Operations	7,043	93	17,771	00	78,289	00	059

FCU 109B

Our Federal CREDIT UNION

Ref *	Item CLASSIFICATION OF LOANS OUTSTANDING	A. Number	B. $ Amount	¢	Acct code no.
	74 Degree of delinquency. a. current and less than 2 months	2,714	4,894,602	00	060
	b. 2 to less than 6 months	4	387	50	061
	c. 6 to less than 12 months	1	563	30	062
	d. 12 months and over	1	1,058	20	063
	e. Total loans (sum of 74a thru 74d) (must equal 1e + 2)	2,720	4,896,611	00	064
	OTHER LOAN INFORMATION	A. Number	B. $ Amount	¢	Acct. code no.
	75. Loans sold and being serviced by the credit union				065
	76. Real estate loans made during current year	14	400,000	00	066
	77. Total loans made during current year (include real estate loans)	637	2,370,490	00	067
	78. Total loans made since organization	6,700	48,564,910	00	068
	79. Total loans charged off since organization		58,503	00	069
	80. Recovery of loans charged off since organization		46,500	00	070
	81. Net loans charged off since organization		12,003	00	071
	MISCELLANEOUS INFORMATION				
	82. Dollar amount of forward commitments to purchase (securities, etc.)				072
	83. Number of members at end of month		2,044		073
	84. Number of potential members		8,176		074

We certify, to the best of our knowledge and belief, this statement and the related statements are true and correct and present fairly the financial position and the results of operations for the periods covered.

G. L. White — Certified correct by: (Please Print)
202 - 357-1460 — Telephone No.
G.L. White — Treasurer-Manager (Signature)
1/1/X2 — Date
Geofrey Lerner — President/Authorized Officer
1/1/X2 — Date

* Numbers in this column refer to notes to financial statements, letters refer to supplementary schedules which are attached.

FINANCIAL PERFORMANCE LETTER - 1982 NATIONAL CREDIT UNION ADMINISTRATION

CREDIT UNION: [redacted]

CHARTER NO: [redacted]
PEER GROUP: OCCUPATIONAL FIELD OF MEMBERSHIP
5-10 MILLION ASSET RANGE
638 CREDIT UNIONS IN THE PEER GROUP

REG/SE/DIST: 5D48
CONTACT DATE: 06/82 PAGE 1
EWS CODE: 1

THE FOUR PAGES OF THIS REPORT HAVE BEEN PREPARED FROM DATA SUBMITTED BY YOUR CREDIT UNION TO NCUA FOR THE PAST 5 YEARS. THE REPORT'S PURPOSE IS TO PROVIDE MANAGEMENT AND DIRECTORS A TOOL TO IDENTIFY KEY TRENDS, ANALYZE PAST PERFORMANCE, AND SET FUTURE GOALS. THE USE OF THIS DATA REQUIRES JUDGMENT - WITHOUT THIS HUMAN ELEMENT, THESE PAGES ARE JUST A COLLECTION OF RATIOS AND DOLLAR FIGURES.

TO ASSIST IN YOUR ANALYSIS, THE FIRST PAGE HIGHLIGHTS THOSE RATIOS WHICH INDICATE THE FINANCIAL AREAS MOST IN NEED OF REVIEW IN YOUR CREDIT UNION. THE SECOND PAGE LISTS 10 RATIOS MEASURING DELINQUENCY, EXPENSES, RESERVES, SOLVENCY AND PROFITABILITY THAT HAVE PROVEN TO BE GOOD INDICATORS OF FINANCIAL STRENGTHS AND WEAKNESSES. THESE NUMERICAL RATIOS ARE ALSO CONVERTED TO A PERCENTILE NUMBER. THESE 10 NUMBERS WERE AVERAGED AND A NEW OVERALL PERCENTILE OF 74 WAS COMPUTED FOR YOUR CREDIT UNION. THIS TOTAL PERCENTILE MEANS THAT 26 % OF ALL FEDERAL CREDIT UNIONS HAD STRONGER COMBINED FINANCIAL RESULTS IN 1982 THAN DID YOUR CREDIT UNION.

PAGE 3 LISTS THE BALANCE SHEET AND INCOME DATA COLLECTED FOR YOUR CREDIT UNION IN A 5-YEAR FORMAT FOR EASY YEAR-TO-YEAR COMPARISON. THE FOURTH PAGE LISTS RATIOS CALCULATED FROM THE FINANCIAL DATA, ALONG WITH THE SAME RATIO FOR YOUR CREDIT UNION'S PEER GROUP, WHICH IS LISTED ABOVE. THIS PAGE ALLOWS IN-DEPTH ANALYSIS OF CRITICAL AREAS IDENTIFIED IN THE FIRST TWO PAGES.

TO BEGIN YOUR REVIEW, LISTED BELOW ARE THE PERFORMANCE AREAS AND RATIOS IN WHICH YOUR CREDIT UNION HAD A PERCENTILE SCORE OF 25% OR LESS IN 1982.

YOUR CREDIT UNION'S PERFORMANCE IN THE 10 KEY INDICATORS RESULTED IN NO PERCENTILE RATINGS LESS THAN THE 25TH PERCENTILE.

THE FOLLOWING PAGE LISTS ALL TEN FINANCIAL RATIOS FROM WHICH THE ABOVE WERE SELECTED.

FINANCIAL PERFORMANCE REPORT
FINANCIAL COMPARISON 1981 - 1982

CREDIT UNION: [redacted] CHARTER NO [redacted] REG/SE/DIST: 5048

BELOW ARE THE RATIO VALUES (EXPRESSED AS A %) AND PERCENTILE RANKINGS ASSIGNED FOR EACH OF THE 10 KEY RATIOS FOR YEARS 1981 AND 1982. YOUR PERCENTILE RANK SHOWS WHERE YOUR CREDIT UNION STANDS IN RELATION TO OTHER CREDIT UNIONS IN EACH AREA OF FINANCIAL PERFORMANCE, AFTER TAKING INTO CONSIDERATION THE DIFFERENCES BETWEEN PEER GROUPS. YOUR OVERALL PERCENTILE IS BASED UPON THE AVERAGE OF THE SUM OF THE INDIVIDUAL PERCENTILES AND INDICATES WHERE YOUR CREDIT UNION'S FINANCIAL PERFORMANCE STANDS IN RELATION TO THE FINANCIAL PERFORMANCE OF ALL CREDIT UNIONS.

		1981		1982	
		RATIO	PERCENTILE	RATIO	PERCENTILE
EXPENSES **	THE 3-YEAR COMPOUNDED GROWTH RATE OF OPERATING EXPENSES MINUS THE 3-YEAR COMPOUNDED GROWTH RATE OF TOTAL INCOME	(3.8)	64	(2.7)	57
RESERVES **	THE 5-YEAR COMPOUNDED GROWTH RATE OF RESERVES AND UNDIVIDED EARNINGS MINUS THE 5-YEAR COMPOUNDED GROWTH RATE OF LOANS	17.3	73	17.2	66
MARKET GROWTH **	% INCREASE (DECREASE) IN TOTAL SHARES FROM THE PRIOR YEAR	15.0	78	25.5	78
RESERVES **	% INCREASE (DECREASE) IN TOTAL RESERVES AND UNDIVIDED EARNINGS FROM THE PRIOR YEAR	32.8	70	19.1	58
CAPITAL **	RESERVES AND UNDIVIDED EARNINGS AND SHARES DIVIDED BY SHARES	115.2	85	114.4	82
EXPENSES **	TOTAL OPERATING EXPENSES (EXCLUDING INTEREST AND PROVISION FOR LOAN LOSSES) DIVIDED BY AVERAGE ASSETS	3.8	46	3.9	46
PERSONNEL ** EXPENSES	SALARIES AND BENEFITS AS A % OF GROSS INCOME	14.4	46	15.0	43
PAYOUT RATIO **	DIVIDENDS AS A % OF GROSS INCOME	47.5	27	52.1	34
CHARGE-OFFS **	NET CHARGE-OFFS DIVIDED BY AVERAGE LOANS (DATA NOT AVAILABLE IN 1981)	******	***	0.2	51
DELINQUENCY **	TOTAL DELINQUENT LOANS AS A % OF TOTAL LOANS	1.2	69	1.4	71
	OVERALL PERCENTILE		86 ==		74 ==

TO PROVIDE A LONGER TERM PICTURE, THE ABOVE INFORMATION SHOULD BE REVIEWED ALONG WITH THE 5-YEAR FINANCIAL HISTORY AND THE 5-YEAR RATIO ANALYSIS WHICH FOLLOW. ONCE TRENDS ARE IDENTIFIED, THE 'WHYS' OF A STATISTIC CAN BE DISCUSSED. PRIORITIES FOR ACTION AND GOALS CAN THEN BE SET FOR THE CREDIT UNION.

RUN DATE: 03/18/83 NCUA REGION - AUSTIN

5 YEAR FINANCIAL HISTORY (ALL DATA AS OF DECEMBER 31)

REG/SE/DIST: 5D48 CREDIT UNION CHARTER NUMBER: [redacted] NAME: [redacted]

	.......1978.......		.......1979.......		.......1980.......		.......1981.......		.......1982.......	
	AMOUNT	% CHANGE	AMOUNT	% CHANGE	AMOUNT	% CHANGE	AMOUNT	% CHANGE	AMOUNT	% CHANGE
ASSETS:										
CASH	-49,572		28,681		9,970		53,991		165,396	
COMMON TRUST INVEST.	205,631		72,559		32,701		560		476,382	
DEP. IN S&L	0		0		0		0		1,050,000	
DEP. IN BANKS	0		242,042		0		350,000		0	
DEP. IN OTHER CRED U	0		39,117		897,928		513,327		39,293	
SHARES IN CLF	0		0		0		0		16,193	
US GOVT & AGENCY SEC	0		0		0		0		0	
ALL OTHER INVEST.	0		12,618		0		0		21,908	
INVEST. LOSS ALLOW.	0		0		0		0		0	
LOANS TO MEMBERS	4,322,353	15.1	4,533,938	4.8	4,529,418	-.1	5,274,562	16.4	5,800,440	9.9
(LOAN LOSS ALLOW)	(5,765)		(6,902)		(6,674)		(3,945)		(4,975)	
LOANS TO OTHER CU	0		0		0		0		0	
LAND AND BUILDINGS	56,278		55,160		54,044		235,179		393,962	
OTHER FIXED ASSETS	3,411		2,430		5,171		7,912		67,026	
ALL OTHER ASSETS	22,184		12,964		122,796		45,934		24,980	
TOTAL ASSETS	4,554,520	13.5	4,992,607	9.6	5,645,354	13.0	6,477,520	14.7	8,050,605	24.2
LIABILITIES & CAPITAL:										
ACCOUNTS PAYABLE	50,479		67,423		157,160		42,490		24,341	
DIVIDENDS PAYABLE	0		0		84,811		103,755		141,920	
NOTES & INT. PAYABLE	0	*****	0	*****	0	*****	0	*****	0	*****
OTHER LIABILITIES	2,698		65		19,913		27,539		25,634	
TOTAL LIABILITIES	53,177	-67.9	67,488	26.9	261,884	288.0	173,784	-33.6	191,895	10.4
REGULAR SHARES	4,098,100	16.3	0	-100.0	4,312,627	*****	4,448,509	3.1	5,252,825	18.0
SHARE DRAFTS	0	*****	0	*****	0	*****	0	*****	186,233	*****
IRA/KEOGH	0		0		0		0		151,158	
SHARE CERTIFICATES	0	*****	0	*****	445,538	*****	1,024,610	129.9	1,279,094	24.8
TOTAL SHARES	4,098,100	16.3	4,419,217	7.8	4,758,165	7.6	5,473,119	15.0	6,869,311	25.5
REGULAR RESERVE	220,189		247,755		279,089		313,284		346,764	
OTHER RESERVES	82,462		83,285		78,285		83,029		82,978	
UNDIVIDED EARNINGS	100,592		174,860		267,928		434,304		559,653	
TOT RES & UND EARN	403,243	25.4	505,900	25.4	625,302	23.6	830,617	32.8	989,395	19.1
TOT LIAB & CAPT	4,554,520	13.5	4,992,607	9.6	5,645,354	13.0	6,477,520	14.7	8,050,605	24.2
INCOME & EXPENSE:										
GROSS INCOME	499,584	25.8	551,332	10.3	626,674	13.6	793,903	26.6	953,032	20.0
SALARIES & BENEFITS	78,027	-1.3	83,936	7.5	92,814	10.5	114,726	23.6	143,281	24.8
TOTAL OTHER OPER EXP	87,955	32.3	88,741	.8	102,098	15.0	118,159	15.7	140,222	18.6
NON-OPER INCOME(EXP)	0	*****	192	*****	5	-97.3	22,953	*****	170	-99.2
PROV FOR LOAN LOSSES	4,000	*****	1,000	-75.0	1,500	50.0	5,500	266.6	14,178	157.7
TOTAL DIV & INT	249,597	23.4	276,013	10.5	305,866	10.8	377,691	23.4	496,747	31.5
TRANSFER TO STAT RES	6,491		27,566		31,333		34,195		33,482	
NET INCOME	73,514		74,268		93,068		166,585		125,292	
OTHER INFORMATION:										
HIGH DIVIDEND RATE	7.00		N.A.		.00		.00		7.50	
UNS/AUTO LOAN RATE	.00/ .00		.00/ .00		15.00/ .00		18.00/ .00		18.00/12.00	
NEW MONEY LOANED	4,636,028	-13.6	4,533,938	-2.2	4,529,418	-.1	4,594,800	1.4	4,659,436	1.4
NET CHRG OFF LOANS	3,142	199.5	-394	-112.5	1,727	.0	8,230	376.5	13,057	58.6
FULL/PART-TIME EMPL	0/ 0		0/ 0		6/ 1		6/ 1		6/ 2	
MEMBERS	3,187		3,372		3,750		4,167		4,903	
POTENTIAL MEMBERS	3,500		5,500		5,250		5,250		5,250	
MONEY MARKET ACCTS	0		0		0		0		0	

RUN DATE: 03/18/83 NCUA REGION - AUSTIN

5 YEAR RATIO ANALYSIS (ALL DATA AS OF DECEMBER 31)

REG/SE/DIST: 5D48 CREDIT UNION CHARTER NUMBER: [redacted] NAME: [redacted]

	1978	1979	1980	1981	1982	1982 PEER
I. GROWTH RATIOS (AVERAGE COMPOUNDED GROWTH)						
SHARES - 5 YR	*****	*****	*****	11.6	13.7	10.6
LOANS - 5 YR	*****	*****	*****	8.8	7.6	1.9
RESERVES & UNDIVIDED EARN (NET WORTH) - 5 YR	*****	*****	*****	26.2	24.8	16.4
MEMBERS - 5 YR	*****	*****	*****	12.2	11.3	6.3
BORROWERS - 5 YR	*****	*****	*****	10.4	11.7	.7
GROSS INCOME - 3 YR	N.A.	17.8	12.0	19.9	23.3	20.7
TOTAL EXPENSES (LESS DIV. INT & PLL) - 3 YR	N.A.	8.9	9.5	16.1	20.6	18.4
II. BALANCE SHEET ANALYSIS:						
LOANS/SHARES	105.4	102.5	95.1	96.3	84.4	70.5
LOANS/ASSETS	94.9	90.8	80.2	81.4	72.0	63.3
RESERVES & UNDIVIDED EARNINGS/ASSETS	8.9	10.2	11.1	12.8	12.3	8.2
RESERVES & UNDIVIDED EARNINGS & SHARES/SHARES	109.9	111.6	113.2	115.2	114.4	109.3
BORROWINGS/RES & UNDIVIDED EARN & SHARES	.0	.0	.0	.0	.0	.5
LIQUIDITY RATIO	N.A.	N.A.	16.4	16.2	26.4	36.3
REGULAR SHARES/ALL SHARES & BORROWINGS	100.0	.0	90.6	81.2	76.4	72.7
III. INCOME & EXPENSE ANALYSIS (% OF GROSS INCOME):						
LOAN INCOME	98.1	93.9	84.3	79.5	81.7	70.9
SALARY & BENEFITS	15.6	15.2	14.8	14.4	15.0	14.3
INTEREST EXPENSE	.7	.0	.0	.0	.0	.5
OPERATING EXPENSE LESS INTEREST & PLL	32.5	31.3	31.1	29.3	29.7	30.1
PROVISION FOR LOAN LOSSES (PLL)	N.A.	N.A.	.2	.8	1.4	3.2
TRANSFER TO STATUTORY RESERVE	1.2	5.0	5.0	4.3	3.5	2.5
DIVIDENDS	49.9	50.0	48.8	47.5	52.1	57.3
NET INCOME	14.7	13.4	14.8	20.9	13.1	6.1
IV. LOAN ANALYSIS:						
YIELD ON AVERAGE LOANS	12.1	11.6	11.6	12.8	14.0	13.4
RESERVE & SURPLUS/LOANS	9.4	11.3	13.9	15.8	17.1	13.9
DELINQUENT LOANS/LOANS	N.A.	N.A.	.7	1.2	1.4	3.5
NET CHARGE-OFFS/AVERAGE LOANS	.0	.0	.0	.1	.2	.5
NET CHRG-OFF/REG RES & RES FOR LOAN LOSSES	1.3	-.1	.6	2.5	3.7	12.1
NET CHARGE-OFFS/GROSS INCOME	.6	.0	.2	1.0	1.3	2.9
V. MANAGEMENT ANALYSIS:						
YIELD ON AVERAGE ASSETS	11.6	11.5	11.7	13.0	13.1	12.8
COST OF FUNDS/AVERAGE ASSETS	5.9	5.7	5.7	6.2	6.8	7.4
NET SPREAD	5.7	5.7	6.0	6.8	6.2	5.4
OPERATING EXP LESS INT & PLL/AVER ASSETS	3.7	3.6	3.6	3.8	3.9	3.9
NET INC BEFORE TRANS TO STAT RES/AVER ASSETS	1.8	2.1	2.3	3.3	2.1	1.1
ESTIMATED LOAN MATURITY IN MONTHS	11.0	12.0	12.0	14.1	15.3	17.9
MEMBERS/POTENTIAL MEMBERS	91.0	61.3	71.4	79.3	93.3	75.9
BORROWERS/MEMBERS	49.2	58.9	57.4	55.1	50.0	47.9
VI. PRODUCTIVITY RATIOS						
AVERAGE SHARE BALANCE	$ 1,285	$ 1,310	$ 1,268	$ 1,313	$ 1,401	$ 1,750
AVERAGE LOAN BALANCE	$ 2,751	$ 2,279	$ 2,103	$ 2,293	$ 2,369	$ 2,768
LOANS/FULL-TIME EMPLOYEES	$ 0	$ 0	$ 696	$ 811	$ 828	$ 758
ASSETS/FULL-TIME EMPLOYEES	$ 0	$ 0	$ 868	$ 996	$ 1,150	$ 1,226
SALARY & BENEFITS/FULL-TIME EMPLOYEES	$ 0	$ 0	$ 14,279	$ 17,650	$ 20,468	$ 18,255
OPERATING EXPENSE LESS INTEREST & PLL/EMPL	$ 0	$ 0	$ 29,986	$ 35,828	$ 40,500	$ 39,170
OPERATING EXPENSE LESS INTEREST & PLL/MEMBER	$ 50	$ 51	$ 51	$ 55	$ 57	$ 64

Item 7

7

The feasibility of consolidating the three separate insurance funds.

The consolidation of the three federal insurance funds into a single entity would substantially increase governments' role in determining the shape and structure of financial markets. Such a consolidation would reverse the intent of deregulation, which is to allow the future of financial institutions to evolve in the competitive environment of the market as a result of decisions by thousands of separate institutions. A single insurer would combine in one person or Board an extraordinary amount of authority to define the competitive structure of the financial market place, to determine who would be allowed entry, and to decide the life and death of hundreds of independent corporations through merger or liquidation. These decisions would, overtime, inexorably replace the supervisory power of the regulator with the economic and financial clout of the insurer. As events progressed, the regulatory function would tend to become an arm of the insurer, not the reverse, for without insurance coverage and cooperation the regulator is unable to make a final decision on almost any critical issue of safety and soundness. How a consolidated insuring organization decided issues such as the pricing of insurance, the scope of coverage, and the implementation of risk rating would, when combined with the "administrative" activities described above, create a concentration of enormous economic consequence and political power. Instead of a pluralistic system of institutions developing different specialities for different markets with varying financial structures, the single insurer would force homogenization on the market participants. This corporation's decisions, not just administratively, but about the extent of government backing for insured institutions would have a substantial impact on the economy. We believe that no matter how well intentioned or thought out, the creation of one federal insurance agency would lead to changes that would go far beyond the simple administration of federal insurance and deeply affect the economic structure and ultimately the well being of the country. A single Federal insurer could even rival the Federal Reserve System as a prime mover in the country's economic fortunes.

Why would this occur and what are the advantages of the present system that would be lost?

The arguments for consolidation of the three insurance funds generally include the administrative efficiency of locating essentially the same function in only one Agency, the possibility of cost savings from elimination of duplicate bureaucratic activities, and the establishment of a uniform system for the consumer. Having one insurer would preclude the possibility of one segment of the financial industry "stealing the march" an the other because of a slightly different insurance interpretation.

Each of these potential benefits is based on false premises about the operations of the insurance funds and their impact on the general public and the industries they insure.

Differences Within the Funds

The common belief is that because each fund insures up to $100,000 per account, because each charges its insured institutions 1/12 of 1% of insured savings as a premium, and because each is managed by an independent agency of government that they essentially perform the same function. While the insurance protection to the consumer may look the same, the relationship of each insurance fund with its industry is very different. Each of the insured financial industries' asset structure is dramatically different, the risk exposure to each fund results from very dissimiliar activities and the methods each Agency uses to fulfill its $100,000 commitment to an account holder when an individual institution has a problem is unique to each industry. Banks, S&L's and credit unions have different capital structures, different financial options available when problems occur, dramatically different asset portfolios, and varying degrees of cooperation between the regulator and the insurance fund.

Deregulation Causes Specialization

While some have argued that in an increasingly deregulated environment these differences will be lost, we believe that deregulation is more likely to accentuate and reward differences and specialized expertise, not uniformity. Contrary to the common homilies about deregulation leading to a so called "level playing field" and homogenized institutions, we believe that it is regulation that creates uniformity in activity, rates paid, financial structures, and scope of activity. Deregulation will accentuate the particular strengths of individual institutions and reward individual excellence. In this environment it is critical that credit unions retain their own insurance fund in order for it to provide specialized insurance assistance for the safe and sound development of the credit union system.

This point of view was expressed by many commentators on this study:

> At first glance, such a proposal to consolidate funds appears to offer diversity of insurance risk, maximization of resources, and efficiency in government. However, upon further analysis, the costs of such a program far outweigh any perceived benefits.
>
> The insurance decision-making process will be severely altered, with individuals making insurance decisions that have no credit union experience. Credit unions are democratically controlled, co-operative financial institutions that serve limited segments of the general population. As such, their operations, management practices, and problems are far different from those problems encountered by banks and savings and loans.
>
> The NCUSIF has traditionally sought innovative solutions to credit union problems. For example, sponsor closings, plant layoffs, regional and local economic downturns, and sources and uses of liquidity, are unique to credit unions and require credit union solutions, not banking solutions. In a consolidation, we are convinced that with the FDIC as the major force in a combined insurance agency, there will be a natural tendency to solve all credit union problems with banking solutions. We view such action as detrimental to the future of the credit union movement. (National Association of State Credit Union Supervisors (NASCUS))

As described in earlier sections the differences in the activities of the NCUSIF are due to the very obvious differences between credit unions and other financial institutions. The average federal credit union has total assets of $3.9 million, 2,285 members, and total reserves of $253,000. More than 85% of all credit unions are under $5.0 million in total assets. Natural person federally insured credit unions over $100 million are only 39.

These differences were repeatedly stressed by respondents to underscore the need for a separate credit union insurer.

"Credit Unions Are Member Owned Cooperatives"

> We strongly believe that consolidation of the NCUSIF with other insurance funds is a mistake. Credit unions, as a member-owned cooperative, have an orientation and commitment to their membership. The ability to understand and monitor this environment needs to continue from an agency that understands the unique role and effect credit unions play in the financial services environment. Further, we feel the identity and the impact that credit unions would have on a consolidated agency would be lost in the maze of other kinds of financial entities. (California Share Guarantee Corporation)

"Seven out of Eight Credit Unions are Under $5 million"

> Through some economics of operation could and should result I believe the end result would be disastrous for federal credit unions and NCUSIF.
>
> Despite the trend of large credit unions to emulate banks, credit unions are still quite different from banks and S&Ls. For example, 7 out of 8 are under $5 million. There is a distinct diffference between the philosophy of FDIC as compared to that of FSLIC, as demonstrated by the way each deals with problem cases. There is a far greater difference in the case of credit unions compared with either.

I would be fearful that any consolidation of programs would tend to diminish the differences to the point where they would tend to disappear. I think small credit unions would suffer most, and I would expect most to seek insurance elsewhere, or to give up entirely.

I do not believe a single fund would be administered to deal effectively with the problems of non-profit cooperative institutions of the size of most credit unions when it must deal also with the needs and problems of large banks. (Texas Share Guaranty Credit Union)

"Risks from Credit Unions Very Different Than Bank Risks"

Credit unions, commercial banks, and savings and loan associations have always occupied separate identifiable positions in the financial world. With the advent of deregulation – if it comes to pass completely — the differences between commercial banks and savings and loan associations will be significantly reduced. Credit unions will remain separate and distinguishable from the other financial institutions — especially since credit unions are restricted in dealing with qualified members and not the general public. The significant dissimilarities in capitalization are such that credit unions will always remain apart from banks and savings and loan associations. The operating and capitalization divergencies are such that credit unions will continue to have a need for supervision and guarantees in a manner different from the other institutions and therefore, the separate guarantee fund for credit unions should be continued.

The three types of financial institutions — banks, savings and loan associations and credit unions — have separate and different types of problems and risk exposure. Commercial lending and international banking present potential problems and exposures for banks which do not exist for credit unions. Credit unions do not have significant or extensive mortgage loans of long-term nature as is the case with savings and loan associations.

These different characteristics present materially different and distinguishable risks to the respective insurance funds. It does not seem equitable for the insurance fund for the credit unions to have the larger exposure to the risks attributable only to the other financial institutions. Each type of institution should be required to share the costs attributable only to the risks associated with it.

We believe that consolidaton of the three insurance funds is not in the best interest of the financial institutions and should not be approved. (Florida Credit Union Guaranty Corporation)

"A Consolidated Fund Would Be Bank Dominated"

> We do not believe that credit union insurance needs would be adequately addressed by a single federal fund that would be completely dominated by the needs of the largest banking institutions. Being at the bottom of the asset totem pole, credit union needs would be completely submerged by the needs of the great banks. Credit union representation in the administration of a consolidated fund would be minimal and the big banks would dominate the government of such a fund. Appointment to the fund's governing board would be dictated by the bankers' associations in order to insure that the bankers' needs were met. The staffing of the organization administering a consolidated fund would be oriented toward dealing with banking problems. Our recent experience with federal agencies that deal primarily with banks such as the Federal Reserve have shown that they have very little understanding or knowledge of what a credit union's business is all about. (Idaho Credit Union League)

Common Purpose But Dissimiliar Activity

The three funds' single purpose of assuring the general public is accomplished with differing methods because the needs of each Agency's financial institutions are radically different. To create a single insurer to meet the concern of maintaining public confidence is to err in how this function is carried out in practice. It makes no more sense to have a single federal insurance agency because each members acount is insured to $100,000 than it does to charter only one life insurance company offering the general public $100,000 policies. Although the function is outwardly similar the activities of NCUA insurance are quite specialized in offering this outward assurance to credit union members when problems occur.

Cost Savings? Who will Benefit

One of the arguments for a single fund is the perception that there might be some cost savings. There are two issues — whether this would in fact occur and if by chance it did, how this fact would justify change. Right now each insurance fund is entirely self funded by its industry. NCUA's Insurance Fund has never received any federal funds even at its inception as did the FDIC and FSLIC. Credit unions pool their money via premiums and NCUA manages this risk pool. Credit unions have in each of the last two years supported a special premium assessment to enable the fund to build reserves to a level of 1% of insured shares. There are no taxpayer dollars used anywhere in the fund. If credit unions wish to maintain their own fund, and have demonstrated the willingness to pay for it, then the cost becomes a credit union issue not a public responsibility or concern

> Emphasis should be placed on the fact that share insurance funds are not "out of the general fund of the U. S. Treasury ", but in fact are contributions made by individual credit unions, for their own benefit. (Ohio Credit Union League)

> It is important that Congress understands that the NCUSIF is totally supported from within the credit union industry. These are actually member funds paid by the member-owners, the credit union members, into the NCUSIF to insure the safety and soundness of their cooperative venture. A single fund could not possibly maintain the separateness of the source of funds. (New York Credit Union League)

> A large segment of credit unions supported the self-help effort of increased assessment to make the present insurance fund stronger. We did not receive one adverse comment on the additional assessment made by NCUA this past year. Credit unions know what is required for them to remain strong and viable and one giant insurance fund will not in itself improve or reduce existing problems. (Vermont Department of Banking & Insurance)

Single Federal Insurer Would Increase Credit Union Costs

But could there be cost savings? We know of no reason to expect any and even if direct costs remained the same then the indirect costs to credit unions by the creation of a single federal insurer of could rise substantially. A single insurer would be a new federal agency by which credit unions would be regulated. New rules, forms, reports, even exams would be necessary if the insurer is to monitor the insured. These points are made repeatedly by the credit union respondents.

> The government's record of reducing costs through agency consolidation is not very impressive. We believe the result would be a larger, more expensive bureaucracy. (South Carolina Credit Union League)

> Because of the complexity of the variations in insurance requirements I can easily project increased operating costs (in a consolidated fund). I simply do not feel or believe that there would be any reduced operating costs, nor would there be any reasonable probability of reduced insurance premiums. (Ohio Credit Union League)

> I believe that credit unions would suffer an additional cost of regulation if the regulations by the insurers for credit unions became a regulation for insurance by the FDIC and FSLIC. It is my considered opinion that the duplication in regulatory supervision of banks and savings and loans has to do with the fact that the federal government has allowed the FDIC and FSLIC to become a second regulator of financial institutions, instead of the risk-taker for certain risks defined by contract. If the NCUSIF were to be merged in with the FDIC and FSLIC I believe the same sort of duplication of regulation would take place in the credit union sector. Up to this point, I do not believe the NCUSIF has been regulating credit unions as they have not conducted nor found it necessary to conduct insurance exams on top of regulatory exams. If the regulatory agency adequately peforms its job of supervising and examining financial institutions there is no need for the insurance fund to duplicate that effort. (Texas Credit Union Department)

NCUA's Insurance/Regulatory Structure More Efficient

The current NCUA structure where insurance is a part of one regulatory agency has many inherent efficiencies. The Fund needs a very limited staff in Washington and in each Region to oversee the administrative functions of insurance, principally the management and disposition of acquired assets. This is due to the fact that in reality every examiner, field supervisor and office manager at one time or another becomes involved in insurance problems. This is because insurance is an extention of supervisory activity in NCUA. When a source of recapitalization for a credit union becomes necessary each examiner is responsible for working with the credit union to develop a workout plan. There are not "insurance specialists" in the agency; all employees contribute when use of the Fund is deemed necessary.

Consolidation Brings Dangers

While it is difficult to identify any benefits from merger of the funds — to the general public, to the institutions, to the Agencies or to the government — there are some very obvious dangers which a merger would create.

The first is that credit unions, their unique needs and cooperative development, would be overwhelmed by the sheer magnitude of their insurance "partners."

> The net result would be that credit unions would be lost in the maze of banks and thrifts who generally are much larger in asset size and better able to lobby for their own benefit. Cost to credit unions would very likely increase over the cost of maintaining the present insurance fund with no direct benefits. (State of Vermont Department of Banking and Insurance)

> I feel very strong that credit unions would suffer if the three separate insurance funds were consolidated. Because of the size of banks, bankers would dominate both savings and loans and credit unions. (Kansas Department of Credit Unions)

> A single federal fund would be difficult to administer because it would bring unlike situations into a single operation and would eliminate any strong industry input pertaining to what is needed and expected. (Washington Credit Share Guaranty Association)

It is not just the "lack of specialist attention "that disturbs credit union respondents, it is also the concern that a single insuring entity would ultimately lead to the destruction of the identity of the credit union movement through the "common melting pot" of insurance.

> While such a merger might conceivably cause certain economies to be realized, consideration must be given to the concern of totally breaking down the barriers between various types of financial institutions. The consolidation of insurance funds, and subsequently of the regulatory agencies, might well signal the death knell of financial cooperatives as we know them today. (New York Credit Union League)

Because of this fear, one result would be that credit unions could seek to move away from federal and into the various private insurance funds.

> Many credit unions would seek insurance coverage other than that provided by a "big" federal overlord to remain with their own type of institution and more local contact. (Vermont Credit Union League)

> The FDIC would obviously dominate a combined fund. There is no evidence suggesting that the banks might be impartial or sympathetic when addressing credit union needs. Consolidation would most assuredly cause credit unions in North Carolina to look to the North Carolina Savings Guaranty Corporation for share insurance. (North Carolina Credit Union League)

> Should consolidation take place, many credit unions would be tempted to move away from Federal insurance. This movement to private insurance has proven relatively easy in Illinois. Several credit unions have switched to NDGC within the last 12 months as the initial projection of shareholder concern over switching from a federal to private insurance plan has not proven an obstacle. (Illinois Department of Financial Institutions)

Finally there is a distinct feeling that credit union insurance funds raised from credit union members would end up benefitting the "competition".

> Credit unions will end up sharing the cost of bank and savings & loan failures resulting from their bad investments. (Idaho Credit Union League)

> Private insurers are becoming more popular nation-wide and are insuring a greater number of credit unions each year. With the additional resources of these private insurers, it is not necessary to burden the credit union industry with the problems being incurred by all financial institutions (Indiana Credit Union League)

> I also definitely do not feel that credit union insurance needs would be adequately addressed by a single federal fund. We would have problems allocating funds to the various financial institutions and one or the other would feel that they were funding the other industry. (North Dakota Credit Union League)

At this time there are over 45 million member acounts in credit unions. Credit unions have met the test of the competitive market. Credit unions have also met the test of supporting their own insurance fund. The total of federally insured credit unions, 16,570 is almost as great as the total number of insured banks and S&L's together.

Credit Unions Want Their Own Insurance Fund

In a poll of its members NAFCU reported that the vast majority of the 235 respondents opposed consolidation of the Funds.

> Would you support consolidation of the insurance funds (FDIC, FSLIC, NCUSIF) into one fund? YES: 16.3% NO: 69.0% NO OPINION: 14.7%

A State League respondent echoes this same position.

> Conversations with credit union leaders across North Carolina clearly point out that consolidation of the insurance funds or merger of the supervisory agencies is not desirable. Quite to the contrary, our people are very much opposed to any consolidation. We must remember that though they offer a complete portfolio of financial services, credit unions are unique and different. They will remain so as long as they are membership cooperatives. (North Carolina Credit Union League)

The unique needs of credit unions require a specialized insurer:

> Credit unions are cooperatives established by Act of Congress. They are non-profit and uniquely different in the mandate they have to provide services to member owners. Credit unions are not judged by greater or lesser standards —just different standards. (New York Credit Union League)

Instead of developing appropriate responses to the problems of financial cooperatives, credit union leaders believe a single insurance fund would just end up "writing out checks" to resolve problems.

> I don't feel credit union insurance needs would be adequately addressed by a single Federal fund. I think it would come down to just writing the checks when a credit union is liquidated and that would be the end of it. (Utah Credit Union League)

> With regard to the issue of whether the insurance needs of credit unions would be met by a consolidated fund, CUNA believes the needs would be met only in the very narrow sense that, in the event of liquidaton, members would receive payouts to cover shares. However, as past experience has demonstrated there is more to the insurance process than simply providing a guarantee of share value. The combination of stabilization

> efforts between NCUSIF and CLF, for example, has provided help to a substantial number of credit unions, and it is unlikely that such efforts could continue if the insurance funds were combined. CUNA is seriously concerned that a consolidated fund would result in a shifting away from helping credit unions to weather adverse economic circumstances to an increased focus upon reducing potential insurance fund losses. Because CUNA views stabilization as an inextricable part of the insurance program and, therefore, a legitimate insurance need, we feel that in the most realistic sense of credit union insurance needs would not be satisfactorily met by a consolidated fund. (CUNA)

Credit unions are concerned about an additional federal bureaucracy impacting upon the 16,570 federally insured credit unions.

> We feel that state credit union supervisors have developed a good working relationship with NCUA personnel with regard to the federal insurance function. We feel that a merger of the federal insurance funds will significantly alter that relationship and lead to more, not less, federal pre-emption of state regulatory initiatives.
>
> Where once there was one federal regulatory insurance agency, now there would be two entities at the federal level for credit unions. This would create additional layers of bureaucracy, and will work to weaken NCUA's traditional advocacy role.
>
> The concept of combining the insurance funds will yield more bureaucracy, not less. The approaches needed now are patience, understanding, and innovative solutions to credit union problems. We feel that these aspects an be best accomplished within the existing structure. (NASCUS)

Credit Unions Support Their Own Fund

The credit union movement is proud of its history of taking care of its own problems.

> It should be emphasized that the NCUSIF are funds provided by credit unions for self insurance. The fact that there is a back up provision which would allow the insurance fund to call on the U. S. Treasury, changes that aspect to a small degree. However, the fact is that no funds of the federal

> government have been used to stabilize or payout liquidating federal credit unions. The credit union movement has demonstrated its ability to take care of its own losses and it has demonstrated its willingness to address its own problems by way of increased premium assessments. (Texas Credit Union Department)

> Not a single tax dollar is spent in connection with the Fund's operation and any government involvement in recommending a commingling of the money with other funds is misplaced. This is particularly true in light of the fact that there is total lack of support by the movement for consolidation. It is also particularly true because of the responsible manner in which the movement has demonstrated its willingness to address its own problems. The fact that NCUA's goal of achieving a 1% equity/shares ratio for the Fund over the next several years was wholeheartedly supported by the great majority of credit unions last summer is ample evidence of the movement's commitment to responsible insurance policies. (CUNA)

A Separate Credit Union Insurance Fund is in the Public Interest

Combination of the three funds we believe would hurt, not help, all insured financial institutions. In their comments credit unions also mentioned these larger public policy issues. A single federal insuror would create a monopoly or, as one respondent wrote, there would be no "other game in town."

> Merging the funds would also tend toward the anti-competition approach which is not typical of our American way of doing business.

This would inevitally create pressures for "look-a-like" institutions.

> To homogenize all financial institutions whether it be deposit insurers or regulators would detract from a credit union's unique role as a financial institution. (Michigan Dept of Commerce)

> A second possible result of consolidation is the homogenization of financial institutions. This is the result which we fear most. We must continue to recognize that the distinctions that exist between financial institutions are beneficial. A diverse delivery system for financial services improves competition. Competition yields better service at lower cost. (Michigan Credit Union League)

The merger or consolidation of the NCUA insurance fund is unnecessary, unwanted, and entirely inappropriate. We believe that credit unions and the general public are best served by an independent dynamic and evolving credit union system which has the responsibility for its own insurance.

QUESTIONNAIRE FOR NCUA INSURANCE STUDY
REQUIRED BY GARN-ST GERMAIN
DEPOSITORY INSTITUTION ACT

ITEM 1

"The current system of deposit insurance and its impact on the structure and operations of depository institutions."

Because of the all encompassing dimensions of this question, it is vital that all groups provide comments. Without the unique credit union historical perspective concerning deposits and the evolution of the present system of deposit insurance, the study would fail to recognize the different roles played by such insurance activities with respect to credit unions.

We would like to review from your vantage point the history of credit union shares and deposits (member accounts) and the history of as many insurance activities (both Federal and state) as you are familiar with. Please include statistical facts and figures as may be available to you. Please conclude with a summary of the present credit union system of deposit insurance and your assessment of its impact on the structure and operations of credit unions.

In developing this history and assessment, we would appreciate your reflections on the following matters:

a. When considering the 36 year period of federal credit union history in which there was no deposit insurance, ...

   1. How did this affect credit union growth?

   2. How did this affect credit union safety and soundness and member losses?

   3. How did we solve problems without insurance?

   4. Are the insurance needs of member-owned cooperatives such as credit unions different than other financial institutions? If so, in what way.

   5. What was the role of the league stabilization funds?

   6. What is your assessment of this period without insurance?

b. When considering the 12 year period since the beginning of NCUA insurance and many of the state deposit insurance programs, ...

   1. What have been the major advantages? Have there been any disadvantages?

2. How has insurance affected credit union growth? Safety and soundness?

3. What is the history of state laws governing insurance?

4. Do any credit unions exists without deposit insurance today? How are they doing?

5. What is your assessment of this period with insurance?

ITEM 2

"The feasibility of providing depositors the option to purchase additional deposit insurance covering deposits in excess of the general limit provided by law and the capabilities of the private insurance system, either directly or through reinsurance, to provide coverage in excess of the general statutory limit."

a. We are aware of instances where this is currently being done for credit unions through some state insurance programs. If you have any firsthand experience with this practice, please provide a description and assessment.

b. Since many credit unions do not have deposits above the insurance limits, what would your thoughts be about credit unions having the option to purchase less than $100,000 worth of insurance?

    1. Would you envision the possibility of combining this lower Federal amount with less expensive private insurance if it were available?

    2. Would this lower amount of Federal insurance affect the competitive relationship with other federally insured institutions? For example, a bank would continue to advertise "all accounts insured to $100,000 by the FDIC" (or some higher amount if the coverage were raised) and as an alternative a credit union might advertise "accounts are 100% insured" and go on to explain the breakdown of the coverage.

ITEM 3

"The feasibility of basing deposit insurance premiums on the risk posed by either the insured institution or the category or size of the depository institution rather than the present flat rate system."

a. What are your general comments on the pros and cons of risk rating by the Federal insurers?

b. If you are in favor of risk rating at the Federal level, how would you recommend this be done?

c. What are your views on a basic minimum leval of Federal insurance at a fixed rate coupled with risk-rated insurance from the private system for amounts above the minimum?

ITEM 4

"The impact of expanding coverage of insured deposits upon operations of the insurance funds, including the possibility of increased or undue risk to the funds."

a. What is your assessment of the benefits which were received when the insurance limit was raised in prior years ($20,000 - $40,000 - $100,000)?

b. Should you have to pay for insurance you don't need?

c. What is your perception of the increased risk to the NCUSIF of higher coverage?

ITEM 5

"The feasibility of revising the deposit insurance system to provide even greater protection for smaller depositors while fostering a greater degree of discipline with respect to large depositors."

We have no specific questions as this pertains to deposits in credit unions. Any general comments would be welcome.

ITEM 6

"The adequacy of existing public disclosure regarding the condition and business practices of insured depository institutions, and providing an assessment of changes which may be needed to assure adequate public disclosure."

a. Do you have any good examples of the benefits which credit unions have received from their longstanding practice of local disclosure?

b. Should their local disclosure be revised to include for example; investment policies? certain business practices? board meetings? lending policies? other information?

ITEM 7

"The feasibility of consolidating the three separate insurance funds."

a. Do you believe this would result in any cost effectiveness resulting in lower premiums?

b. Do you feel credit union insurance needs would be adequately addressed by a single Federal fund? Would credit unions be likely to move away from Federal insurance?

c. Should it be emphasized: (1) that these funds are not Federal funds, but rather credit union funds? and (2) that the credit union movement recently demonstrated its willingness to address its own problems when it supported the effort to increase the size of the NCUSIF with the specific premium assessment?

RESPONDENTS TO GARN ST-GERMAIN INSURANCE STUDY

Mr. Gary B. Wolter
President
Alabama Credit Union League
617-37th Street South
Birmingham, AL 35222

Mr. R. L. Shultz, Jr.
President
Arkansas Credit Union League
P. O. Box 425
Little Rock, AR 72203

Mr. W. F. Broxterman
President
California Credit Union League
P. O. Box 2322
Pomona, CA 91766

Mr. Edmund Leong
President
Hawaii Credit Union League
1654 South King Street
Honolulu, HI 96826

Mr. William Tell
President
Idaho Credit Union League
P. O. Box 5056
Boise, ID 83705

Mr. Morton E. Jester
President
Indiana Credit Union League
P. O. Box 19428
Indianapolis, IN 46219

Mr. J. Dennis Montgomery
President
Iowa Credit Union League
P. O. Box 1076
Des Moines, IA 50311

Mr. William C. Sterner
President
Kansas Credit Union League
8410 West Highway 54
Wichita, KS 67209

Mr. Clare Chapman
Chairman
Washington Credit Union
Share Guaranty Association
Post Office Box WCUL
Bellevue, WA 98009

Mr. Donald J. Schaefer
Executive Vice President
Wisconsin Credit Union Savings
Insurance Corporation
5011 Monona Drive
Madison, WI 53716

Mr. Tom Gaines
President
State Credit Union Share
Insurance Corporation
Chattanooga, TN 37421

Mr. Roy L. Gove
Deputy Superintendent
Department of Business Regulation
Bureau of Banking
State House Station 36
Augusta, Maine 04333

Mr. Edward G. Welch
Deputy Commissioner of Banks
Bank Supervision
Commonwealth of Massachusetts
Department of Banking
100 Cambridge Street
Boston, MA 02202

Mr. A. Roy MacAskill
Director of Financial
Institution Examination
Vermont Department of Banking
and Insurance
120 State Street
Montpelier, VT 05602-9974

Mr. Charles F. Handley
Financial Examiner Supervisor
Arkansas Securities Department
#1 Capitol Mall - 4B-206
Little Rock, AR 72201

Mr. William R. Miller
Director
Division of Financial Institutions
Department of Banking and Securities
911 Leawood Drive
Frankfort, KY 40601

Mr. Oliver G. Barnett
Assistant Commissioner of Banking
Division of Credit Unions
Department of Banking
James K. Polk State Office Building
505 Deaderick Street, Second Floor
Nashville, TN 37219

Mr. Ray Johnson
State Supervisor
Department of Financial Institutions
Credit Union Department
421 East Capitol Avenue
Springfield,IL 62706

Mr. Michael Fitzgerald
Director
Credit Union Division
Financial Institutions Bureau
P. O. Box 30224
Lansing, MI 48909

Mr. James Miller
Assistant Commissioner
Banking Division
Department of Commerce
Metro Square Building, 5th Floor
Seventh and Robert Streets
St. Paul, MN 55101

Mr. Doyle R. Brown, Jr.
Director
Division of Credit Unions
State of Missouri
P. O. Box 1607
Jefferson, MO 65102

Mr. Leeland Stenehjem
Commissioner
Department of Banking and
Financial Institutions
1301 State Capitol
Bismarck, ND 58505

Mr. Richard Ottow
Acting Commissioner
Office of Commissioner of Credit Unions
310 North Midvale Boulevard
P.O. Box 7960
Madison, WI 53707

Mr. John B. Rucker,Jr.
Administrator
Kansas Credit Union Department
535 Kansas - Room 1008
Topeka KS 66603

Mr. Snider Campbell
Credit Union Supervisor
Financial Institutions Division
Commerce and Industry Department
Lew Wallace Building
Sante Fe, NM 87503

Mr. John P. Parsons
Commissioner
Credit Union Department
State of Texas
914 East Anderson Lane
Austin, TX 78752-1699

Mr. David Kwant
Supervisor of Credit Unions
Department of Financial Institutions
P. O. Box 89
Salt Lake City, UT 84110-0089

Mr. Willis F. Kirpatrick
Director of Banking, Securities,
Small Loans and Corporations
Department of Commerce
Division of Banking
Pouch D
Juneau, AK 99811

Mr. Jack Carlson
Chief, Financial Services Division
Department of Corporations
600 South Commonwealth Avenue
Los Angeles, CA 90005

Mr. R. H. Lewis
Supervisor
Division of Savings and Loan
Associations
General Administration Building
Room 217C
Olympia, WA 98504

Mr. Jim Williams
President
Credit Union National Association
P. O. Box 431
Madison, WI 53701

Mr. Mal Nestlerode
Executive Vice President
National Association of Federal Credit Unions
1111 North 19th Street
Arlington, VA 22209

Mr. William M. Drohan
Executive Director
National Association of State
Credit Union Supervisors
1499 Chain Bridge Road
Suite 201
McLean, VA 22101

Mr. Norman D. Asher
President
Kentucky Credit Union League
3615 Newburg Road
Louisville, KY 40218

Mr. Kenyan Bixby
Managing Director
Michigan Credit Union League
P. O. Box 5210
Detroit, MI 48235

Mr. Rudolph D. Dill
Managing Director
Mississippi Credit Union League
P. O. Box 9575
Jackson, MS 39206

Mr. Frank Danczyk
President
New Mexico Credit Union League
8402 Zuni Road, SE
Albuquerque, NM 87108

Mr. Berris Gordon
Managing Director
New York State Credit Union League
1211 Western Avenue
Albany, NY 12203

Mr. Curtis Ring
Executive Vice President
North Carolina Credit Union League
P. O. Box 6808
Greensboro, NC 27405

Mr. Arnold Paulson
President
North Dakota Credit Union League
P. O. Box 1956
Bismarck, ND 58501

Mr. John Gouch
President
Ohio Credit Union League
1201 Dublin Road
Columbus, OH 43215

Mr. Thomas E. Delk
President
South Carolina Credit Union League
P. O. Box 1787
Columbia, SC 29202

Mr. Jack Eaker
President
Texas Credit Union League
P. O. Box 225147
Dallas, TX 75265

Mr. Don Bleazard
President
Utah Credit Union League
P. O. Box 27277
Salt Lake City, UT 84127

Mr. Eugene H. Farley, Jr.
President
Virginia Credit Union League
P. O. Box 11469
Lynchburg, VA 25406

Mr. Bruce Rouillard
President
Washington Credit Union League
P. O. Box WCUL
Bellevue, WA 98009

Mr. Jose Alonzo
President
West Virginia Credit Union League
Route 5, Box 143-A
Parkersburg, WV 26101

Mr. John P. Hill
President
Wisconsin Credit Union League
10025 West Greenfield Avenue
Milwaukee, WI 53214

Mr. Robert Rose
Operations Officer
California Credit Union Share
Guaranty Corporation
2322 South Garey Avenue
P.O. Box 2322
Pomona, CA 91769

Mr. Richard Filip
Executive Vice President
Florida Credit Union Guaranty
Corporation
8000 South Orange Avenue
Suite #108
Orlando, FL 32809

Mr. John E. Martin
President
Georgia Credit Union Deposit
Insurance Corporation
2990 Brandywine Road
Suite 220
Atlanta, GA 30341

Mr. William Kavaney
President/Treasurer
Massachusetts Credit Union
Share Insurance Corporation
950 Mechanics Bank Tower
Worchester, MA 01608

Mr. Sam J. Rizzo
President
National Deposit Guaranty Corporation
555 Metro Place N.
Suite 185
Dublin, OH 43017

Mr. Peter A. Nevola
President
Rhode Island Share and
Deposit Indemnity Corporation
1060 Park Avenue
Cranston, RI 02910

Mr. Buford B. Lankford
President
Texas Share Guaranty Credit Union
400 East Anderson
Post Office Box 14584
Austin, TX 78761

Mr. Don B. Duncan
President
Utah Share and Deposit Guaranty
Corporation
25 East 1700, S.
Post Office Box 26008
Salt Lake City, Utah 84115

Mr. Giles E. Wood
Executive Vice President
Virginia Credit Union Share
Insurance Corporation
Post Office Box 11469
Lynchburg, VA 24506

○